No. 78- 606

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said Public Utilities Commission, ET AL.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

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Petitioner, The Pacific Telephone and Telegraph Company, respectfully prays that a writ of certiorari issue to review the judgment of the Supreme Court of California entered on July 13, 1978, upholding the decision of the California Public Utilities Commission entered on September 13, 1977.

OPINIONS BELOW

The final judgment of the California Supreme Court (App. A, p. 1A) is reported at 21 Cal. 3d, Official Advance Sheets, No. 21, minutes, p. 3 (1978). The judg-

ment was entered without opinion, one judge dissenting from the Court's refusal to issue a writ of review. The decision of the California Public Utilities Commission (App. B, pp. 3A-74A) is as yet unreported.

JURISDICTION

The judgment of the California Supreme Court was entered July 13, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3).

QUESTIONS PRESENTED

1. Did the California Public Utilities Commission violate the provisions of the Internal Revenue Code §§ 46(f) and 167(*l*), and therefore the Supremacy Clause of Article VI of the United States Constitution, by requiring petitioner to pass on to its customers federal tax benefits of accelerated depreciation and investment tax credits, when petitioner is forbidden by federal law to receive such tax benefits if it passes them on rather than having them available, as Congress contemplated, for capital investment?

2. Did the California Public Utilities Commission deprive petitioner of its property without due process of law in violation of the Fourteenth Amendment: (a) by reducing rates on the basis of outdated financial estimates when actual data more favorable to petitioner were before the Commission, in violation of this Court's ruling in *West Ohio Gas Co.* v. *Public Utilities Commission*, 294 U.S. 79 (1935); (b) by making rates on the assumption that petitioner was eligible for accelerated depreciation and the investment tax credit, when the Commission's ratemaking methods themselves destroyed that eligibility?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article VI and the Fourteenth Amendment to the Constitution; pertinent provisions of the Internal Revenue Code of 1954, 26 U.S.C. §§ 46(f), 167(a), 167(*l*), 167(m); and the Treasury Regulations thereunder, 26 C.F.R. §§ 1.167(*l*)-1(a)(1),-1(h)(1), (6), are reprinted in Appendix C, pp. 75A-93A.

STATEMENT

This case arises from a conflict between federal tax policy as enacted into law by Congress in 1969, 1971 and 1975, when it set conditions on the use of accelerated depreciation and the investment credit by regulated public utilities, and state ratemaking policy regarding those federal tax benefits, as ordered by the California Public Utilities Commission ("Commission") and the California Supreme Court.

Petitioner, The Pacific Telephone and Telegraph Company ("Pacific"), is a California corporation engaged in the business of rendering telephone service in the State of California. As such, its intrastate rates and services are subject to regulation by the Commission, pursuant to the California Public Utilities Code.

Under the Internal Revenue Code, Pacific cannot be eligible for the tax benefits of accelerated depreciation and the investment credit unless its rates are

established in a manner consistent with ratemaking standards prescribed under §§ 167(l) and 46(f).

The decision of the Commission, as upheld by the California Supreme Court, reduced Pacific's intrastate telephone rates by adopting new ratemaking methods with respect to these federal tax benefits.[1] California's ratemaking methods misinterpret the requirements for eligibility for those tax benefits. After studying the Commission's decision, the Internal Revenue Service has issued formal rulings that these tax benefits will not be available to Pacific if the Commission's decision is placed in effect. Thus, if the Commission's order becomes final, Pacific will face a federal tax liability in excess of one billion dollars.

A. Legislative Background

Congress first allowed the use of accelerated methods of depreciation for federal income tax purposes in 1954, when it enacted § 167(b) of the Internal Revenue Code. The effect of accelerated depreciation, as contrasted with straight-line depreciation, is to produce higher deductions and lower income taxes in the early years of an asset's life, and to produce lower deductions and, consequently, higher income taxes in later years. Accelerated depreciation thus acts to defer federal taxes from early years to later years, leaving

[1] The Commission decision also applies to General Telephone Company of California ("General"). General also intends to petition this Court for certiorari. General and Pacific have filed a separately bound Joint Appendix, referred to herein as "App."

funds with the taxpayer available for investment during the intervening period. This is what Congress intended: "The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion." H.R. Rep. No. 83-1337, 83d Cong., 2d Sess. 24 (1954).

As originally enacted, the 1954 Code contained no special provisions relating to the treatment of accelerated depreciation for regulated utilities. In the absence of explicit federal limitations on regulatory agencies, the stated Congressional intent of stimulating the economy by fostering capital formation was partially thwarted in ensuing years. Since federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the tax deferral resulting from accelerated depreciation as a reduction in cost of service, and therefore lowered rates. In this way, the agencies immediately passed through to customers the amount of the current tax deferral. This practice, known as "flow-through" ratemaking, prevented the accumulation and investment of capital that Congress had intended when it enacted the 1954 Code. By reducing the utility's income the practice also reduced the amount of federal taxes to be paid.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, § 167 was amended as part of the Tax Reform Act of 1969.[2]

[2] Tax Reform Act of 1969, Pub. L. No. 91-172, § 441(a), 83 Stat. 625 (1969). *See Federal Power Comm'n* v. *Memphis Light, Gas*

Under newly-enacted § 167(*l*), a utility such as Pacific which had not previously used accelerated depreciation for federal tax purposes could thereafter use accelerated depreciation *only* (1) if the utility used the "normalization" method of accounting in its books of account *and* (2) if the regulatory agency used the normalization method in setting rates.[3]

Under normalization as prescribed by the Code and Regulations, (1) a utility's tax expense for ratemaking purposes must be computed as though "normal" (*i.e.*, straight-line) depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (*i.e.*, the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service.[4]

and Water Div., 411 U.S. 458, 461 (1973); H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-134 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-176 (1969).

[3] Normalization accounting for deferred taxes is required for the financial reports of non-regulated businesses under generally accepted accounting principles. A.P.B. Opinion No. 11 (December 1967).

[4] I.R.C. § 167(*l*)(3)(G); Treas. Reg. § 1.167(*l*)-1(h)(1), (6) (App. C, pp. 82A, 86A, 88A). Essentially, the same normalization requirements govern Pacific's eligibility to depreciate its property using shorter lives under the asset depreciation range system and the class life system. *See* I.R.C. § 167(m); Treas. Reg. §§ 1.167(a)-

By allowing utilities such as Pacific to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: First, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital, and second, to avoid the additional loss of federal tax revenues that results when flow-through ratemaking is imposed.[5]

Two years after enacting § 167(*l*), Congress adopted a new investment tax credit, also designed to provide capital to stimulate modernization and expansion.[6] The investment credit is a direct dollar-for-dollar offset against taxes. It is earned in the year certain types of depreciable property are first placed in service. As with accelerated depreciation, Congress made the availability of the credit to public utilities such as Pacific conditional on strict adherence by regulatory agencies to ratemaking standards prescribed in the Internal

11(b)(6), 1.167(a)-12(a)(4)(iii). For purposes of this petition, reference to accelerated depreciation includes these other depreciation systems as well.

[5] The federal government's tax revenue loss from flow-through ratemaking results first, from the utilities' use of accelerated depreciation itself, and second, from the reduction in the utilities' taxable income because of lower revenues under flow-through ratemaking. It was the revenue loss attributable to the latter factor that Congress found unacceptable. *See* H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 132 (1969).

[6] Revenue Act of 1971, Pub. L. 92-178, § 105(e), 85 Stat. 503. *See* H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 23-26 (1971). The 1971 Act established a 4 percent investment credit for public utility property used to furnish telephone service; the level of the credit was changed to 10 percent as part of the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301(a), 89 Stat. 26.

Revenue Code. By enacting what is now § 46(f),[7] Congress intended to achieve a result "essentially similar" to the normalization rules relating to accelerated depreciation.[8]

B. Proceedings Below

Pacific did not use accelerated depreciation in computing its federal income tax until after the passage of the Tax Reform Act of 1969 and thus can be eligible only if its rates are made using normalization. In 1970, the Commission held it would thereafter set Pacific's rates under normalization, stating that "it would now be futile to consider the relative merits of flow-through and normalization" *Re Pacific Tel. & Tel. Co.*, 71 Cal. P.U.C. 590, 594 (1970). The Supreme Court of California, however, annulled this order, suggesting that the Commission invent a "fictitious factor" and thereby "strike a balance between [the] two extremes" of flow-through and normalization. *City and County of San Francisco* v. *Public Utilities Commission,* 6 Cal. 3d 119, 130, 490 P.2d 798, 804 (1971).

In 1973, a new rate proceeding was initiated and in 1974 the Commission granted a rate increase. The Commission again concluded that only strict adherence to the ratemaking requirements of the Internal Revenue Code would preserve eligibility for the federal tax

[7] This provision was originally enacted as § 46(e) in 1971, but was redesignated as § 46(f) under the Tax Reduction Act of 1975.

[8] H.R. Rep. No. 92-533, 92d Cong. 1st Sess. 25 (1971); S. Rep. No. 92-437, 92d Cong., 1st Sess. 38 (1971).

benefits, and that loss of eligibility "would be a financial disaster to Pacific and would cause a substantial deterioration of service within a few years." *Re Pacific Tel. & Tel. Co.,* 77 Cal. P.U.C. 117, 161 (1974). This decision was appealed by intervenors advocating flow-through ratemaking. The California Supreme Court affirmed, except as to the federal tax issue. It found that the Commission had not understood the full scope of its powers. It therefore remanded the tax aspect of the case so that the Commission could consider the tax issues with full knowledge of its authority. *City of Los Angeles* v. *Public Utilities Commission,* 15 Cal. 3d 680, 708, 542 P.2d 1371, 1390 (1975). The proceeding below followed. It was expressly limited to a determination of the ratemaking methods the Commission would apply to accelerated depreciation and the investment tax credit.

In the proceeding below, the Commission once again held it to be in the public interest that petitioner's eligibility for these tax benefits be preserved and found that loss of eligibility would create "staggering" problems (App. B, p. 22A). Nevertheless, a divided Commission adopted two new ratemaking methods which departed from the prior interpretations of federal requirements that were known to preserve eligibility. For accelerated depreciation, the Commission adopted a ratemaking method called "averaged annual adjustment" ("AAA"), and for the investment credit, the Commission adopted a method called "annual adjust-

ment" ("2A").[9] The Commission held that these rate-making methods

> ". . . maintain the eligibility of the utilities to use accelerated depreciation and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General." (App. B, pp. 49A-50A.)

Applying these ratemaking methods (together with imputed accelerated depreciation with flow-through for property acquired in 1968 and 1969), the Commission ordered Pacific to make rate refunds for past periods totaling $206,000,000 (through January 1, 1977) and to reduce present rates by an amount in excess of $60,000,000 per year.[10] Thus the order effected a substantial flow-through of the tax benefits. The $60,000,000 on-going rate reduction, for example, represents flow-through of approximately $55,000,000 per year over prior normalization methods. Nevertheless, the Commission majority rejected Pacific's contentions that the new ratemaking methods were plainly inconsistent with the eligibility requirements under the Internal Revenue Code and would therefore deprive Pacific of the

[9] These ratemaking methods are described at pp. 15-21, *infra*.

[10] Because of the protracted period over which the tax issues were considered, the Commission's decision adjusted rates established in three separate rate proceedings. The Commission granted rate increases in 1974 and 1976. Those rates were subject to refund pending the resolution of this proceeding. A third rate case was pending when the Commission issued its order in this proceeding and the tax issues in that case were covered by the order in the present case.

very tax benefits it was ordered to pass on to its customers.[11] The Commission also rejected a recommendation by the Administrative Law Judge in his proposed report that a 180-day period be allowed before the order was placed in effect so rulings from the Internal Revenue Service could be obtained.[12]

Pacific proceeded promptly to submit ruling applications to the Internal Revenue Service to determine eligibility. Pacific requested the Commission to participate before the Internal Revenue Service so that its position would be fully stated, but the Commission (two members dissenting) refused.[13]

On June 8 and July 27, 1978, the Internal Revenue Service issued rulings that, if the Commission's decision is placed in effect, Pacific will forfeit its eligibility for both accelerated depreciation (App. D, pp. 95A-115A) and the investment credit (App. E, pp. 133A-142A). Immediately after the issuance of the first ruling, Pacific requested the Commission to reconsider its decision in light of the position of the Internal Revenue Service. The Commission refused.[14]

Pacific had petitioned the California Supreme Court for review before the Internal Revenue Service rulings

[11] *E.g.*, Ex. 7; Post-hearing Brief, pp. 5-47; Application for Rehearing, pp. 10-21. Pacific also raised below the Constitutional arguments here asserted. E.g., Ex. 7, pp. 24-25; Prehearing Memorandum on Refund Plans, pp. 4-7; Post-hearing brief, pp. 48-74; Application for Rehearing, pp. 17-28.

[12] Proposed Report, January 19, 1977, pp. 38-39, 42.

[13] Cal. P.U.C., Decision No. 88215 (December 6, 1977).

[14] Cal. P.U.C., Decision No. 88972 (June 14, 1978).

were issued.[15] The California Supreme Court denied Pacific's petition for review on July 13, 1978.[16] Under California law, the California Supreme Court's action constitutes an affirmance on the merits.[17] The Commission has granted a stay of its decision while review is being sought in this Court.

REASONS FOR GRANTING THE WRIT

I

The California Decision Is Directly At Odds With The Plain Meaning And Purpose Of The Federal Tax Laws, With The Treasury Regulations Implementing Those Laws, With The Position Of The Internal Revenue Service And, Therefore, With The Supremacy Clause Of Article VI

In the area of federal taxation, as in other areas of primary federal competence, the States are obliged by the Constitution to abide by national law. *Art. VI of*

[15] Pacific urged that the Commission's decision conflicted with the eligibility requirements provided under the Internal Revenue Code, conflicted with Article VI of the United States Constitution, and denied due process in violation of the Fourteenth Amendment. Petition for Writ of Review in the California Supreme Court, pp. 5-6, 11-71; Reply Brief of Pacific in the California Supreme Court, pp. 4-33.

[16] Pacific had informed the California Supreme Court that rulings were being sought from the IRS and requested, *inter alia,* that the Court defer its decision until after the rulings were issued. The IRS ruling on accelerated depreciation, which was issued on June 8, 1978, was submitted to the California Supreme Court on June 9, 1978. The IRS ruling relating to the investment credit was issued on July 27, 1978, after the California Supreme Court denied review.

[17] *People* v. *Western Air Lines, Inc.*, 42 Cal. 2d 621, 630, 268 P.2d 723, 728, *appeal dismissed,* 348 U.S. 859 (1954).

the Constitution. In this instance, California has misinterpreted federal statutes thereby frustrating the basic Congressional purposes. Intervention by this Court is necessary to preserve federal policy and to ensure compliance with federal standards by California and other States when they interpret the same law.

The federal laws involved here do not compel a state commission to authorize a public utility to take accelerated depreciation or investment credit. The federal laws do, however, impose conditions on eligibility. If eligibility is to be preserved, the commission must allow the utility to retain a specified portion of the current tax deferrals or savings for investment purposes and must not deplete the tax benefits by reductions of the utility's rates.[18] The purpose of the federal laws was to assist the economy by stimulating investment while maintaining the level of federal tax collections,[19]

[18] In *Memphis Light, Gas & Water Div.* v. *Federal Power Comm'n,* 462 F.2d 853, 856-60 (D.C. Cir.), *cert. denied on this issue,* 409 U.S. 941 (1972), the Court of Appeals for the District of Columbia Circuit ruled, in a related context, that the Tax Reform Act of 1969 deprived a regulatory agency of the power to set a utility's rates by imputing accelerated depreciation with flow-through. Relying on clear statements of congressional purpose, the Court held that unless the regulatory agency was willing to place the utility on straight-line depreciation for tax purposes and set rates accordingly, it was required to follow the normalization treatment of accelerated depreciation for ratemaking purposes.

[19] *See, e.g.,* S. Rep. No. 92-437, 92d Cong., 1st Sess. 35-41 (1971); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171 (1969); H.R. Rep. No. 83-1337, 83d Cong., 2d Sess. 24 (1954).

and not to provide short-run reductions in consumer costs.[20]

Starting in 1970, the Commission assured Pacific that it would be eligible for accelerated depreciation.[21] Pacific has filed its tax returns claiming the benefits and now finds its eligibility retroactively jeopardized at least back to 1974. The Commission has claimed to satisfy the federal conditions in determining Pacific's rates. Having made this undertaking to comply with federal law, the Commission—and the California Supreme Court adopting its decision—are bound by the terms of that law. The Supremacy Clause demands no less. "[A] State is without power by reason of the Supremacy Clause to provide the conditions on which the Federal Government will effectuate its policies. Whether the federal policy is a wise one is for the Congress and the Chief Executive to determine." *United States* v. *Georgia Public Service Commission,* 371 U.S. 285, 293 (1963).

A decision such as the Commission's in this case reduces current federal tax collections contrary to Congressional policy, and the economic stimulation resulting from the capital formation Congress sought is

[20] If rates are maintained under normalization, in the long run they will be lower than under flow-through accounting. Tr. 889; 1973 Tr. 573-574, 647-648, 2157; Ex. 27.

[21] Decision No. 77984, 71 Cal. P.U.C. 590 (1970), *reversed, City and County of San Francisco* v. *Public Utils. Comm'n,* 6 Cal. 3d 119, 490 P.2d 798 (1971); Decision No. 83162, 77 Cal. P.U.C. 117 (1974), *reversed in part, City of Los Angeles* v. *Public Utils. Comm'n,* 15 Cal. 3d 680, 542 P.2d 1371 (1975).

frustrated, first by the impact of the partial flow-through of the tax benefits and ultimately by ineligibility. The effect of lost eligibility is the imputation of the tax benefits for ratemaking with partial flow-through since 1974.[22] These results create a serious "obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines* v. *Davidowitz,* 312 U.S. 52, 67 (1941).[23]

A. Accelerated Depeciation.

Pacific can only be eligible to use accelerated methods of depreciation for federal tax purposes if its rates are made using normalization. To explain how the California AAA method destroys that eligibility it is necessary to understand normalization ratemaking.

The utility's rates are set to permit it sufficient revenue to cover (a) its itemized expenses, plus (b) a rea-

[22] While we focus primarily on the AAA and 2A, the decision also directly imposed rate reductions based upon imputed accelerated depreciation with flow-through as to certain pre-1970 property, even though Pacific was entitled to straight line depreciation for such property by § 167(*l*)(1). *See Federal Power Comm'n* v. *Memphis Light, Gas & Water Div.,* 411 U.S. 458, 467 (1973), where this Court stated: "a utility using straight-line depreciation with respect to its pre-1970 property could not switch to accelerated depreciation, nor could a utility be required to switch to flow-through with respect to pre-1970 property." This alone created $43.5 million in refunds and a $5.5 million ongoing rate reduction (App. B, pp. 31A-32A).

[23] *See* S. Rep. No. 91-552, *supra* at 173-174; Staff of Joint Comm. on Internal Revenue Taxation, 91st Cong., 2d Sess., General Explanation of the Tax Reform Act of 1969 at 152 (Comm. Print 1970); *cf. Memphis Light, Gas & Water Div.* v. *Federal Power Comm'n,* 462 F.2d 853 (D.C. Cir. 1972), *cert. denied on this issue,* 409 U.S. 941 (1972).

sonable return on investment (*i.e.,* the rate of return times the rate base). Federal income tax is one of the itemized expenses. To meet the normalization requirements, federal tax expense is computed using straight-line depreciation. Then, to determine the taxes deferred, that same tax expense is recomputed using accelerated depreciation. The difference between the two tax computations is the amount of taxes deferred that year and this amount is placed in a reserve for deferred taxes.[24]

The normalization rules provide that the balance in the reserve for deferred taxes may be used to reduce the rate base.[25] Thus the current period's deferred taxes appear first, as part of the itemized tax expense and second, as the most recent addition to the balance in the reserve which is used to reduce rate base. To keep this synchronized and prevent flow-through, the Regulations limit the deduction from rate base to "the reserve for deferred taxes for the period used in determining the tax expense in computing cost of service".[26]

[24] I.R.C. § 167(*l*)(3)(G); Treas. Reg. § 1.167(*l*)-1(h)(1), (2).

[25] Treas. Reg. §§ 1.167(*l*)-1(a), 1.167(*l*)-1(h)(6). Congress delegated special authority for the Secretary to promulgate regulations to carry out the "purposes" of Section 167(*l*). I.R.C. § 167(*l*)(5). This delegation is in addition to the Secretary's general authority to issue interpretive regulations. I.R.C. § 7805.

[26] Treas. Reg. § 1.167(*l*)-1(h)(6). If the exclusion from the rate base is so limited, the resulting decrease in revenues merely prevents the utility from earning a return on the portion of its operating assets financed with deferred taxes. If an excessive amount is excluded from the rate base through overstating the deferred tax reserve, however, the effect is to flow through a portion of the deferred taxes, thereby defeating normalization.

A part of the ratemaking process which is unrelated to the computation of either the itemized tax expense or deferred tax reserve but which is relevant to understanding the Commission's decision is the "gross up" process. If, for example, the revenue from existing rates covers only the itemized expenses, then multiplying the rate of return times the rate base would give the amount of *net* revenue increase needed to achieve the authorized return. To compute the gross revenue needed to achieve that net revenue, the procedure in California has been to multiply the net revenue needed by a "net-to-gross multiplier". This multiplier has components to account for the effects of uncollectables and state and federal taxes.[27]

The California AAA reduced the rate base for the test year by the average of the deferred tax reserve for the test year plus the succeeding three years.[28] The reserve balances in each succeeding year increased, so that the four-year average far exceeded the reserve for the test year. This violated Treas. Reg. § 1.167(*l*)-1(h)(6). Indeed, Example (1) in that Regulation explicitly shows the California AAA method to be inconsistent with the normalization requirements.[29]

[27] *See* Table 1 to the decision, notes 5 and 6 (App. B, pp. 56A-57A).

[28] The decision does not state why it chose a four-year period. Had it elected to use a longer period for the average it would accomplish 100% flow-through.

[29] Treas. Reg. § 1.167(*l*)-1(h)(6)(iv), Example 1. In that example, rate base, tax expense and cost of service are determined for a single test year, as is true under AAA. The example holds that,

The Commission asserts that it has met the requirements of the Regulations by also computing tax expense in the cost of service for the same four-year period (App. B, p. 27A). But this it has not done. Its computations are set out in Table 1 of the decision (App. B, pp. 56A-57A) and show the Commission merely computed the net revenue reduction associated with the larger deduction from rate base and then converted that to a gross revenue reduction by applying the net-to-gross multiplier. It did not compute the itemized tax expense for the three later years.

Thus the AAA fails. The itemized tax expense for the three years after the test year is ignored, and the additional deferred taxes included in the four-year average reserve have not been included in the itemized tax expense for the test year. Thus, the reserve balance used does not relate to the "period used in determining . . . tax expense in computing cost of service." The net-to-gross multiplier does not enter into the computation of the tax deferral and its use cannot form a basis for eligibility. Indeed if the gross up process is all that is needed to preserve eligibility, every method of excessively reducing rate base would pass muster and the statute and regulations would be a dead letter.

if the amount of deferred taxes excluded from rate base exceeds the balance in the deferred tax reserve at the end of the test year, as is true under AAA, the utility is not following the normalization method of accounting (App. C, p. 89A).

B. Investment Credit.

It is equally clear that the Commission's 2A method will result in loss of eligibility for the investment credit. Section 46(f)(2) of the Internal Revenue Code places precise limits on the amount of the credit which may be flowed through to consumers. Under that section, eligibility for the credit can be maintained only if the credit is flowed through as a reduction in cost of service no more rapidly than ratably over the period for which depreciation expense is recognized on the property that produced the credit. In addition, to assure that there is not excessive flow-through, section 46(f)(2) provides that the rate base may not be reduced by reason of any portion of the credit.

The 2A method automatically reduces rates at the beginning of each year after the test year. For each year after the test year, the method reduces Pacific's test-year cost of service by a ratable portion of the estimated amount of investment credit to be received for the subsequent year. However, the method freezes Pacific's depreciation expense and rate base (as well as other figures) at test-year levels, notwithstanding Pacific's growth in each year after the test year. Thus, each annual reduction in cost of service exceeds the limits of section 46(f)(2) because cost of service is reduced not only by a ratable portion of the new investment credit but also by exclusion of the additional depreciation expense on the property which produced that credit. Moreover, in each year that 2A applies, there is an impermissible reduction in rate base, because

the additional investment which produced the credit is entirely excluded from the rate base.[30]

Although the Commission's decision professes to preserve eligibility for the federal tax benefits, the Commission openly admits that its ratemaking methods are a compromise between established normalization principles and full flow-through (App. B, p. 27A, citing 6 Cal. 3d 119, 130-31 [490 P.2d 798, 804]). But the specific ratemaking standards prescribed by the Internal Revenue Code do not permit any compromise. Nor can it be said that the Commission has narrowly missed preserving eligibility; its misinterpretation of the federal standards is egregious. Under the California interpretation, $55 million of the tax benefits are ordered to be flowed through each year, contrary to Congressional policy and the Code provisions.

In sum, the Commission has based its decision on an erroneous application of federal laws and the decision itself will have direct and far-reaching effects under those laws. The frustration of federal policy and irreparable harm flowing from this error can be prevented only by a decision of this Court and a remand of the case so that rates may be set in conformance with the eligibility requirements of the federal laws.

[30] For example, assume that in a year following a test year Pacific acquired property for $100,000,000, with a useful life of 20 years, producing an investment credit of $10,000,000 and additional annual depreciation expense of $5,000,000. Under 2A, cost of service for the year of acquisition would be reduced not only by $500,000 ($10,000,000 ÷ 20) by reason of ratable amortization of the investment credit, but also by the exclusion from cost of service of the additional depreciation expense of $5,000,000. Moreover, no portion of the $100,000,000 investment in property which produced the credit would be included in the rate base.

II

The Case Presents Important Issues As To The Proper Relationship Between The Federal Tax Laws And State Regulatory Policy. If The California Decision Is Left Standing, Federal Policy Will Be Frustrated And The Consequences To The Petitioner, To Other Public Utilities, And To Consumers Throughout The Country Will Be Devastating And Irreparable

Even when viewed in its narrowest perspective, the effect on Pacific and its ratepayers, this case is of unusual importance. Pacific faces what is probably the largest back tax liability in history. If the Commission's rates are placed into effect and Pacific's eligibility under §§ 46(f) and 167(*l*) of the Code is destroyed, Pacific will owe federal taxes, excluding interest, of at least one billion dollars.[31]

[31] The accelerated depreciation tax deferrals and the tax credits attributable to the intrastate portion of Pacific's business are:

	Reserve for Deferred Taxes	Investment Tax Credit	Annual Total
1974	$ 91,017,000	$ 24,901,000	$115,918,000
1975	108,494,000	62,157,000	170,651,000
1976	117,880,000	75,014,000	192,894,000
1977	129,800,000	88,200,000	218,000,000
1978 (est.)	141,800,000	93,800,000	235,600,000
1979 (est.)	139,900,000	113,100,000	253,000,000
Total	$728,891,000	$457,172,000	$1,186,063,000

The combined total, exclusive of interest, is the amount of the tax deficiency if the decision below is inconsistent with eligibility. (Figures are from Ex. 10A through 1976; the actual figure recorded is shown for 1977; 1978-1979 figures are estimated.)

The effect on Pacific and the people that depend upon its service will be devastating. The amounts attributable to the accelerated depreciation tax deferral and the investment credits have been invested in plant and equipment, as Congress intended, and are not available to pay the back tax liability. The uncontradicted evidence below established that borrowing enough money to finance that liability, Pacific's only alternative, would exhaust Pacific's ability to borrow (Ex. 9, pp. 26-32). The ability to sell common equity has already been impaired, for Pacific's stock sells at only about two-thirds of book value.[32] No common equity has been sold since 1973. Standard and Poor's rating of Pacific's debt securities has fallen precipitously since 1973, resulting in dramatically increased cost of debt and limiting Pacific's ability to sustain its capital investment program.

In examining the consequences if Pacific's eligibility were destroyed, the uncontradicted evidence established that Pacific would then be unable to meet the demand for telephone service (Ex. 9, pp. 31-32; Ex. 11, pp. 4-18); many orders for new or changed service could not be met and within a year 275,000 customers would be waiting for service (Ex. 11, pp. 11-12); existing facilities would be clogged and many local and long distance calls would be delayed or go uncompleted (Ex. 9, pp. 26-34; Ex. 11); and Pacific would be forced to lay off at least 12,500 employees, creating a ripple effect caus-

[32] At the time of trial book value was $20.36 per share [it is now over $22.00]. The stock is traded on the New York and Pacific Exchanges. Ex. 9, p. 14.

ing layoffs by suppliers (Ex. 11, p. 10). The destructive effect on telephone service would unquestionably injure the entire California economy.

The Commission understood this and quite correctly found that loss of eligibility would "not only create service problems . . . but would create staggering financial problems." This would ultimately result in "staggering rate increases" (App. B, p. 22A). Indeed, an appreciation of the problems led two of the three majority Commissioners to state, in a separate concurrence, that "the *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be" (App. B, p. 70A).

Petitioner is caught in the middle. The State of California holds that its action preserves eligibility under the federal tax statutes; the federal agency charged with administering those statutes has ruled that it does not. Eligibility is not within petitioner's control, for it is dependent upon the manner in which the Commission sets the rates.

If the decision below becomes final and the rates which it mandates are placed into effect, the situation will be irreversible. The Commission does not appear to have the authority to correct its ratemaking retroactively even if that were permitted under the Code.[33]

[33] *See City of Los Angeles* v. *Public Utils. Comm'n*, 15 Cal. 3d 680, 705-707, 542 P.2d 1371, 1388-1389 (1975); *Pacific Tel. & Tel. Co.* v. *Public Utils. Comm'n*, 62 Cal. 2d 634, 401 P.2d 353 (1965); I.R.C. § 46(f)(4); Treas. Reg. § 1.167(l)-1(h)(4).

The Internal Revenue Service audit process lags several years behind the filing of the tax returns. Pacific's returns for 1974 and later years have not, as yet, been audited. If the decision below becomes final, the Internal Revenue Service will pursue the audit process that will ultimately lead to assertion of the tax deficiencies. By the time that process is concluded and, as Pacific believes will be the case, eligibility is determined to have been destroyed, there will be no means of undoing the harm and by then the tax liability will have grown to two billion dollars.

The potential impact of the present case reaches far beyond the parties involved. Other utilities in California are already being subjected to orders with similar effect,[34] and other state ratemaking agencies are following the present proceedings closely, for some have only reluctantly met the eligibility conditions set by Congress for accelerated depreciation and the investment credit.[35] Since the effect of the decision below is to reduce rates in the short run, regulatory agencies throughout the country will find themselves under pressure to take similar actions if the Commission's

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[34] *E.g., Sierra Pacific Power Co.*, Decision No. 88337 (Cal. P.U.C. January 17, 1978).

[35] *See, e.g., Re South Central Bell Tel. Co.*, 15 P.U.R. 4th 87, 117-119 (La. Pub. Serv. Comm'n 1976), *remanded on other grounds*, 352 So. 2d 964 (La. Sup. Ct. 1977); *Re Michigan Bell Tel. Co.*, 3 P.U.R. 4th 1, 15 (Mich. Pub. Serv. Comm'n 1973). At the time the Tax Reform Act of 1969 was adopted about half the regulatory agencies required flow-through accounting. *See* S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-172.

decision is left standing. Not only would such actions seriously erode federal policy, but they would occasion unnecessary and grave jeopardy to utilities and give rise to a period of widespread financial uncertainty and consuming litigation. Ultimately, the effects would be borne by consumers throughout the country. Unless this Court resolves the issues presented now, while there is still time to do so effectively, the program Congress established as an aid to investment by utilities and thus as an aid to the economy will become a vehicle of destruction.

III

The Judgment Below Conflicts With The Decision Of This Court In *West Ohio Gas Co. v. Public Utilities Commission*, 294 U.S. 79 (1935), Is Destructive Of Petitioner's Financial Integrity And Deprives Petitioner Of Its Property Without Due Process Of Law In Violation Of The Fourteenth Amendment

It is the essence of this Court's ruling in *West Ohio Gas Co. v. Public Utilities Commission*, 294 U.S. 79 (1935), that due process demands that judgment be based on facts rather than hypotheses or fictions, at least where, as here, the facts were before the decision maker at the time of the decision. *West Ohio* was violated by the decision below in two ways: first, with regard to a question that was on all fours with *West Ohio*, and second, by a ruling that is plainly inconsistent with its rationale.

A. The Violation of *West Ohio*.

In *West Ohio*, this Court held it to be a violation of due process for a regulatory agency to rely on previous

estimates in setting rates and ordering refunds when actual financial results demonstrated that the actual earnings were below the return the agency had found reasonable. The Court held that the refusal of the Ohio Commission to be guided by the actual results before it was an "arbitrary restriction in contravention of the Fourteenth Amendment and of 'the rudiments of fair play.'" 294 U.S. at 81. Mr. Justice Cardozo, for a unanimous Court, reasoned:

> The earnings of the later years were exhibited in the record and told their own tale as to the possibilities of profit. To shut one's eyes to them altogether, to exclude them from the reckoning, is as much arbitrary action as to build a schedule upon guesswork with evidence available. There are times, to be sure, when resort to prophecy becomes inevitable in default of methods more precise. At such times 'an honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances' [citations omitted], is the only organon at hand, and hence the only one to be employed in order to make the hearing fair. But prophecy, however, honest, is generally a poor substitute for experience. * * * We have said of an attempt by a utility to give prophecy the first place and experience the second that 'elaborate calculations which are at war with realities are of no avail' [citations omitted]. We say the same of a like attempt by officers of government prescribing rates to be effective in years when experience has spoken. A forecast gives us one rate. A survey gives another. To prefer the forecast to the survey is an arbitrary judgment. [294 U.S. at 81-82.]

The constitutional principle established in ***West Ohio***

has been regularly followed in most state and federal courts.[36]

In 1974 the Commission set the reasonable rate of return for Petitioner at 8.85% per year[37] and established new rates. In 1976 the Commission granted another rate increase, because Petitioner had not achieved that return under the 1974 rates. By the time the Commission decided this special tax proceeding, the actual experience under those rates was known, was before the Commission, and was not disputed.[38] Pacific earned only 7.57% in 1974, 7.6% in 1975 and 8.1% in 1976.[39] The shortfall in earnings actually ex-

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[36] *E.g.*, *Williams* v. *Washington Metropolitan Area Transit Comm'n*, 415 F.2d 922, 945-46 (D.C. Cir. 1968), *cert. denied sub nom. D.C. Transit Sys., Inc.* v. *Williams*, 393 U.S. 1081 (1969); *Intermountain Gas Co.* v. *Idaho Pub. Utils. Comm'n*, 98 Idaho 718, 722, 571 P.2d 1119, 1123 (1977); *New York Tel. Co.* v. *Public Serv. Comm'n*, 29 N.Y.2d 164, 169-170, 272 N.E.2d 554, 556 (1971); *General Tel. Co.* v. *Michigan Pub. Serv. Comm'n*, 341 Mich. 620, 67 N.W.2d 882 (1954). *But see South Central Bell Tel. Co.* v. *Louisiana Pub. Serv. Comm'n*, 355 So. 2d 253 (La. Sup. Ct.), *cert. denied*, —— U.S. ——, 98 S.Ct. 3103, 57 L.Ed.2d 1142 (1978) (White, J., and Powell, J., dissenting); *Mountain States Tel. & Tel. Co.* v. *Public Utils. Comm'n*, 180 Colo. 74, 81, 502 P.2d 945, 948 (1972).

[37] This was reduced on November 2, 1976 to 8.843%. Cal. P.U.C. Decision No. 86593.

[38] Ex. 9, p. 8; Ex. 10, Part 1. The failure of the existing rates to permit earning the authorized rate of return was again brought to the Commission's attention in Pacific's motion for rehearing (Ex. B to App. for Reh.).

[39] The rate of return figures cited are based upon the Commission's required ratemaking adjustments. The actual financial data (also in evidence and undisputed) is far worse; by a series of "adjustments" that are not the subject of this appeal, the Commission excluded large segments of the rate base and expense. For

perienced was huge: $123 million in 1974; $126 million in 1975; and $79 million in 1976. This was the actual situation before applying the rate reductions ordered by the Commission in this case. The refunds ordered here are $19.5 million for 1974; $61.3 million for 1975; and $57.9 million for 1976. (Tables 1, 3, and 5 of the decision, App. B. pp. 56A, 60A, 64A.) Had the Commission applied its ratemaking adjustments to the actual financial data for those years, the rates could not have been reduced. In the decision below, the Commission nevertheless ignored the shortfall revealed by the actual financial results, ordered the rates set in 1974 and 1976 reduced and ordered refunds reflecting that reduction back to 1974.

We do not argue here that the insufficient rates of past years must be retroactively raised in this proceeding to eliminate the actual shortfall experienced, for California law does not guarantee earning the return authorized. But where the rates in effect actually produced earnings far below the authorized return, the State cannot, consistent with due process, force those inadequate rates even lower.

B. The Decision Has A Destructive Impact On Pacific's Financial Integrity And Thereby Violates The Fourteenth Amendment.

In addition to ignoring the realities of the past, the Commission took no account of the effect of its action

financial reporting the actual return figures were 7.2% for 1974, 7.35% for 1975 and 7.78% for 1976. (All figures relate to the intrastate business only.)

on Pacific's present or future financial integrity. By making rates on the assumption that Pacific is eligible for the federal tax benefits when in fact the ratemaking methods employed themselves destroy that eligibility, the Commission has simply confiscated a large portion of the earnings Pacific should receive.

The Commission's AAA method immediately denies any return on a large amount of investor-supplied capital.[40] In addition, the rate reductions and the effect of retroactive ineligibility for the tax benefits will force the actual rate of return two percentage points or more below that found reasonable by the Commission and California Court.[41]

The effect of the loss of eligibility for the tax benefits is utterly destructive of Pacific's financial integrity and will severely handicap, if not destroy, its ability to attract capital. The enormous risk has already had an adverse effect on Pacific's bond rating. The Commission itself found that the loss of eligibility would result in "the deterioration in financial position . . ." and would "create staggering financial problems . . ." (App. B, pp. 21A-22A).

[40] For example, in the most recent test year the AAA excluded $556 million from rate base when the reserve for the test year was only $374 million. Thus, $182 million of investor capital was denied any return, even if eligibility is assumed.

[41] For past years, recognizing the full rate base and tax expense the actual returns are reduced to about 6.94% in 1974, 6.42% in 1975 and 6.79% in 1976, well below the 8.85% the Commission held reasonable. The return on the equity portion of the capital is forced below the cost of long term debt sold during the period. Ex. 10, Tr. 928.

This action by California directly contravenes the limitations placed upon state regulatory authority by the Fourteenth Amendment. In *Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591 (1944), and *Bluefield Waterworks & Improvement Co.* v. *Public Service Commission,* 262 U.S. 679, 693 (1923), this Court held that the reasonable return safeguarded by the Fourteenth Amendment is one "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital" (320 U.S. at 603). In *Permian Basin Rate Cases,* 390 U.S. 747, 792 (1968), this Court held that an important function of review is to "determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." The impact of the decision below in reducing the rates and risking a billion dollar back tax liability is to destroy investor confidence. Clearly, this regulatory action fails to meet the Constitutional standard. The Commission's own findings on the consequences of the loss of eligibility concede the confiscatory effect.

Regulatory action that is blind to such jeopardy is an abuse of state power. In *New England Tel. & Tel. Co.* v. *Public Utilities Commission,* —— Me. ——, —— A.2d —— (1978),[42] the Maine Supreme Court reversed

[42] The decision is reported in abridged form in [1974 *et seq.*] Util. L. Rep. (CCH) (State volume) ¶ 22,596.

action by the Maine Commission that had reduced rates in a manner that almost certainly would have destroyed eligibility for accelerated depreciation. The Maine Supreme Court held that merely placing the utility "in jeopardy of losing its ability to take accelerated depreciation for federal income tax purposes" was an "unreasonable exercise of power and abuse of discretion" (—— A.2d at ——, [1974 et seq.] Util. L. Rep. (CCH) (State volume) ¶ 22,596.03). Although the Maine decision was rendered under state law, its reasoning is equally applicable under the due process clause.

This Court has held that "rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the [utility] in our economic system remains strong." *Federal Power Commission* v. *Memphis Light, Gas & Water Div.,* 411 U.S. 458, 474 (1973). If left standing, the decision below is destructive of both interests.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that certiorari should be granted.

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Attorneys for The Pacific Telephone and Telegraph Company

October 1978

78-606
78-607

Nos. 78- and 78-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said Public Utilities Commission, ET AL.,
Respondents.

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

JOINT APPENDIX FOR PETITIONERS

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APPENDIX A

APPENDIX A

Order Denying Alternative Writ
S. F. No. 23746

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA
IN BANK

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, ETC.,
Petitioner

v.

PUBLIC UTILITIES COMMISSION, ETC., ET AL., *Respondents.*

(FILED JULY 13, 1978)

Petition for writ of Review DENIED.

Richardson, J., is of the opinion that the petition should be granted.

Motion for leave to intervene is dismissed as moot.

/s/ BIRD
Chief Justice

Order Denying Alternative Writ
S. F. No. 23743

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA
IN BANK

GENERAL TELEPHONE COMPANY OF CALIFORNIA, ETC.
Petitioner,

v.

PUBLIC UTILITIES COMMISSION, ETC., ET AL., *Respondents*

Petition for writ of Review DENIED.

Richard, J., is of the opinion that the petition should be granted.

Motion for leave to intervene is dismissed as moot.

/s/ BIRD
Chief Justice

APPENDIX B

APPENDIX B

Decision No. 87838

September 13, 1977

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application No. 53587

(Filed September 19, 1972)

In the matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.

Application No. 51774

(Filed March 17, 1970)

In the matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.

Application No. 55214

(Filed September 30, 1974;
amended December 13, 1974)

In the Matter of the Application of The Pacific Telephone and Telegraph Company, a corporation, for telephone service rate increases to offset increased wage, salary and associated expenses.

Case No. 9503

(Filed January 30, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, prac-

tices, contracts, service and facilities of The Pacific Telephone and Telegraph Company.

Case No. 9802

(Filed November 26, 1974)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of the Pacific Telephone and Telegraph Company.

Case No. 9832

(Filed November 26, 1974)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.

Application No. 51904

(Filed May 15, 1970;
amended July 17, 1970)

In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.

Application No. 53935

(Filed March 28, 1973)

In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.

Case No. 9100

(Filed August 4, 1970)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of General Telephone Company of California.

Case No. 9504

(Filed January 30, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of all the telephone corporations listed in Appendix A, attached hereto.

Case No. 9578

(Filed July 3, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, practices, contracts, service, and facilities of GENERAL TELEPHONE COMPANY OF CALIFORNIA, a California corporation; and of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.

(Appearances are listed in Appendix A.)

INDEX

Opinion

This is the latest, and hopefully the final, proceeding on the long and tortuous road involving the regulatory rate treatment of accelerated tax depreciation (which includes asset depreciation range, class life system, salvage value, and repair allowance) and the Job Development Investment Credit, now called the Investment Tax Credit (ITC), for two major California telephone utilities, The Pacific Telephone and Telegraph Company (Pacific), and General Telephone Company of California (General). This proceeding results directly from the remand by the California Supreme Court in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680, which annulled that portion of the rate increase granted Pacific in D.83162 dated July 23, 1974 which related to accelerated tax depreciation and ITC. (All other matters decided in D.83162 were affirmed by the court). This annulment also applied to General because in D.83778 dated November 26, 1974 General's accelerated tax depreciation and ITC were treated by this Commission in the same manner as was Pacific's in D. 83162.

At the time the above decision was filed by the court, there was under submission another rate increase proceeding for Pacific, A.55214, in which we issued D.85287 on December 30, 1975. D.85287 granted a rate increase subject to refund to provide for any adjustment in the rates that might be required as a result of the hearings in the instant proceeding. In addition, at the time this matter was remanded by the court two rate increase applications, A.55492 for Pacific and A.55383 for General, were pending. The accelerated depreciation and ITC issues in those pro-

ceedings were removed for final determination in this proceeding.

In the remanded matters this Commission had set rates based on the normalization method of accounting,[1] which involves the computation of rates based on the same method of depreciation, both for depreciation expense and federal income tax expense, while the federal income taxes are actually paid on the basis of a different amount of (accelerated) depreciation expense. Since accelerated depreciation substantially increases the allowable expenses to the utility, the taxable income, and therefore the federal income tax expense of the utility, is substantially below what it would have been had taxes been paid on the ratemaking (straight-line) depreciation basis. The difference between the amount of taxes computed on a straight-line depreciation basis and an accelerated depreciation basis is reflected in a reserve account called the deferred tax reserve. This amount, on an average basis, is deducted from rate base so that the authorized rate of return is not earned on this sum. The deferred tax reserve accumulates from year to year disproportionately to revenues, expenses, and

[1] Internal Revenue Code (IRC) Section 167(*l*)(3)(G), which reads as follows:

"(G) Normalization method of accounting.—In order to use normalization method of accounting with respect to any public utility property——

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

rate base as long as the overall plant additions by the utility continue to grow. To this extent, the taxes set aside in the deferred tax reserve shall never be paid and amount to an actual tax saving, rather than only a deferral. (ITC is defined as a tax credit, thus is a direct tax saving and not a deferral.)

In the remand of D.83162 the Supreme Court held, inter alia, that this Commission has the power to implement an alternative method, e.g., an annual adjustment, of tax expense treatment for accelerated depreciation and ITC. This annual adjustment method was discussed but not used in arriving at the treatment set forth in D. 83162. The Supreme Court ordered this Commission to give consideration to this method, as well as other alternatives, including the possibility of a commensurate adjustment in the rate of return, and to provide for refunds, if appropriate.

Hearings on this remand were held between March 1, 1976 and July 9, 1976 before Commissioner Robert Batinovich and Examiner Philip E. Blecher. The matter was submitted on the latter date subject to the filing of briefs.

The Proposed Report of the examiner was issued on January 19, 1977. Exceptions to the Proposed Report were timely filed by Pacific, General, City of Los Angeles (LA), and Toward Utility Rate Normalization (TURN). These exceptions shall be discussed where appropriate.[2]

Review

D.83162, 83778, and 85287 have exhaustively reviewed and discussed this tax expense issue from its inception. We shall not reiterate that discussion, but shall attempt to confine the review of evidence and discussion of the issues to those old matters still pertinent here, as well as the new matters not previously raised. However, we think a

[2] All transcript corrections requested after the date of submission by Pacific, General, and LA have been adopted.

brief recounting of three California Supreme Court decisions relating to this issue is warranted.

Case 1: City and Council of San Francisco v. Public Utilities Commission, et al. (1971) 6 C 3d 119. This case annulled D.77984, which had provided that Pacific could use accelerated depreciation with the normalization method of accounting as defined in IRC Section 167, because this Commission failed to consider lawful alternatives in the calculation of federal income tax expense. On page 130 the court said: "Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax law are either harsh on the utility or the ratepayers, the Commission may also consider alternative approaches which strike a balance between these two extremes." This statement was quoted with approval in Case 3, infra. Since there has been no substantive change in the applicable federal tax statutes, this quotation is as appropriate today as when made.

Case 2: City of Los Angeles v. Public Utilities Commission (1972) 7 C 3d 331. A general rate increase for Pacific was annulled partly because the Commission computed taxes on the basis of normalization.

Case 3: City of Los Angeles v. Public Utilities Commission (1975) 15 C 3d 680. This is the case which remanded D.83162, et al., for these proceedings. The court stated on page 684 that the Commission took the action in D.83162 in spite of the court having annulled its previous decision in this matter for failure to consider lawful alternatives in the calculation of federal income tax expense (Case 1). The court further said that the Commission set a rate which in its own words would create a windfall for the telephone companies to the detriment to the ratepayers.

Pursuant to the remand in Case 1 the Commission entered D. 80347 dated August 8, 1972 which directed further

hearings into the tax expense problems. These further hearings had not yet been held at the time of the decision in Case 2. In D.80347 we said on page 3: "For the purpose of this opinion only we will compute Pacific's federal tax expense on the basis of accelerated depreciation with flow-through." D.80347 thus ordered a substantial refund amounting to about $176 million, including interest, based on the flow-through method of computation of the federal tax expense. D.80347 also set rates which were in effect through the effective date of D.83162 rates, which was August 17, 1974. The hearings held pursuant to Case 1 were consolidated with A.53587 and resulted in D.83162 where this Commission again adopted the normalization basis for computing federal tax expense, which resulted in Case 3.

In D.74917 dated November 6, 1968, prior to the enactment of the Tax Reform Act of 1969 (TRA) effective January 1, 1970, we determined that Pacific was imprudent in not electing the accelerated depreciation option. For rate-making purposes we imputed accelerated depreciation with full flow-through, though Pacific was paying taxes on a straight-line basis. This procedure was approved in Case 1. TRA allowed utilities to take accelerated depreciation even though they had not taken it before 1969 only if the cost of service (which includes federal income tax expense) was computed on a normalization basis. After the enactment of TRA both Pacific and General reversed their long-standing opposition to accelerated depreciation and elected it on a normalization basis. This election has resulted in the instant proceedings in which we are attempting to comply with the mandate from our Supreme Court to reach an equitable determination of this problem.

Pacific and General argue that accelerated depreciation is allowable only if normalization accounting is used because neither is eligible under IRC Section 167.1 for flow-through accounting. If normalization is not used, then the companies must revert to straight-line depreciation and

the benefits of accelerated depreciation will be lost to both the utilities and the ratepayers. We have previously agreed with this position, as has the court in Case 1, though this result is due only to the intransigence of Pacific and General in not opting for accelerated depreciation when they had the opportunity. While this Commission deplores the actions of Pacific and General, we are again compelled to agree with their interpretation of the tax law. To impute flow-through now in attempting to redress the balance between the utilities and ratepayers, we would ultimately cause the ratepayers substantially higher rates and poorer service while seriously damaging the financial position of the companies. This horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator.

Thus, we are forced to again consider the question of maintaining eligibility for accelerated depreciation on a normalized basis. The primary reference for this purpose is Treasury Regulation 1.167(*l*)-(1)(h)(6).[3] It delineates when the normalization method of accounting is not used, and concomitantly, when it is used. If these criteria are not met, then accelerated depreciation in its entirety will be disallowed creating a huge tax liability for Pacific and General, which will be met with an equally huge deferred

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[3] This regulation, as far as pertinent, reads as follows:

"(6) Exclusion of normalization reserve from rate base. (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(*l*) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking."

tax reserve account, which is paper only, as the monies credited to the deferred tax reserve have already been spent.

The same proposition prevails for ITC. Since ITC became effective in December 1971, General and Pacific have elected ratable (service-life) flow-through (Option 2).[4] This means that the amount of plant investment in the taxable year shall be apportioned on its expected service life for ratemaking purposes.

Neither Pacific nor General was eligible for ITC Option 3[5] (see Case 1, page 130), which allows full flow-through of the tax savings in the year in which the benefit occurred.

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[4] IRC Section 46(f)(2), which reads as follows:

"(2) Special rule for ratable flow-through.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

"(A) Cost of service reduction.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

"(B) Rate base reduction.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection)."

[5] IRC Section 46(f)(3), which reads as follows:

"(3) Special rule for immediate flow-through in certain cases. —In the case of property to which section 167(*l*)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraphs (1) and (2) shall not apply to such property."

Thus, ITC for Pacific and General will be disallowed in its entirety if the taxpayers' cost-of-service for ratemaking purposes is reduced by more than a ratable portion of the credit allowed or if the base to which the taxpayers' rate of return for ratemaking purposes is applied is reduced by more than a ratable portion of the credit.

Assumptions

This discussion and ensuing decision reflect the assumptions set forth below:

(1) Tax Reduction Act becomes effective on January 1, 1970.

(2) As a result of Case 1 and D.80347, Pacific's rates from January 1, 1970 to August 17, 1974 have been promulgated on a flow-through basis. Since these rates are final they cannot now be amended by any action of this Commission. Therefore (a) any action taken in respect to Pacific's rates will apply from August 17, 1974 until the effective date of the rates set in D.85287, which is January 5, 1976; (b) the rates set in D.85287 are subject to refund and any action taken in this decision shall adjust those rates accordingly; and (c) any action taken here shall apply prospectively to the rates to be set in pending A.55492 of Pacific.

(3) General's rates for test year 1970 in D.79367 (effective December 12, 1971) and thereafter have been subject to refund. Therefore (a) any action taken on accelerated depreciation here shall apply to the rates collected by General from December 12, 1971; (b) although ITC was not in existence in test year 1970 used in D.79367, any action taken on ITC shall apply from December 12, 1971, as General has been taking ITC since it has been available; and (c) any action taken here on ITC

and accelerated depreciation shall apply prospectively to the rates to be set in pending A.55383 of General.

(4) Neither Pacific nor General has the option to elect accelerated depreciation on a flow-through basis under IRC Section 167, et seq. (Case 1.)

(5) Both Pacific and General must use a normalization method of accounting to maintain eligibility for accelerated depreciation under IRC Section 167, et. seq.

(6) Neither Pacific nor General has the option to elect ITC on a flow-through basis (Option 3) under IRC Section 46, et seq.

(7) Normalization accounting for accelerated depreciation reduces financial risk and increases cash flow compared to the flow-through treatment for accelerated depreciation.

(8) Both Pacific and General were guilty of imprudent management in their original determination to pay federal income taxes on a straight-line depreciation basis. (Cases 1 and 3.)

(9) The quantification of a rate of return reduction because of the increased cash flow and decreased risk and vulnerability of normalization accounting is difficult and judgmental.

The Evidence

Various alternative methods presented at the hearings may be summarized as follows:

General's Proposals

1. *Three-Year Reserve and Tax Adjustment Method.* This is a variation of a previously proposed three-year pro forma method which, it was argued, was disqualified

under Treasury Regulation 1.167(*l*)-(1)(h)(6) because it used a deferred tax reserve balance that exceeded the amount of such deferred tax reserve for the period used in determining the taxpayers' tax expense. The current proposed method remedies this defect because it considers the additional tax expense for the same period as the deferred tax reserve. It is based on the assumption that the federal income tax will increase in proportion to growth after the test year. The method of computation is as follows:

> At test year the Commission should find a reasonable federal income tax (before ITC) and a reasonable normal growth rate. (General recommends using the compound growth in main stations for the three preceding years.) The test year tax expense would then be increased by applying the growth factor to the intrastate federal income tax (before ITC) for three years into the future and averaging. The test year federal tax expense would then be deducted from the three-year average to determine the additional tax expense to be included in the test year. This amount would then be multiplied by the net-to-gross multiplier to represent the intrastate change in revenue requirement related to the additional tax expense that must be considered for the same period as the deferred tax reserve as determined in the three-year pro forma method.

2. *Annual Reserve and Tax Adjustment.* This is an adaptation of the annual or year-to-year adjustment method (which the Supreme Court discussed in Case 3), which has the same disadvantage as the pro forma method because of its use of an out-of-period deferred tax reserve. The current adaptation of this method makes an annual adjustment for the increase in reserve and also brings the additional tax expense forward for the same time period. The additional tax expense is determined in the same manner as in the three-year reserve and tax adjustment method,

but the rates would only be adjusted one year at a time. The federal income tax before ITC, plus a normal growth rate, would be determined by the Commission and each year's calculation would be based upon the prior year's calculation until a new test year was established.

3. *The Deferred Tax Reserve as No Cost Capital.* This method is used by applying the amount in the deferred tax reserve as a component of the capital structure with zero cost assigned to it. Rate base is not reduced by the amount of deferred tax reserve. The effect is to lower the cost of capital and rate of return found reasonable in general rate proceedings.

Pacific's Proposal

Annual Ratemaking Plan. Pacific would annually tender an estimated full intrastate cost of providing telephone service, keeping as constant all the ratemaking adjustments previously adopted in the latest general rate decision and the last authorized rate of return. No new adjustments or change in authorized rate of return would be permitted but all other elements of cost-of-service would be considered. This is a slightly simplified annual rate case, which everyone agrees is permitted under the existing tax laws.

Staff's Proposals [6]

1. *Pro Forma Annual Adjustment.* Gross revenue requirement reductions are determined by annual adjustments in the deferred tax reserve for the test year and each of the next three years. The average of these four years' reductions is then applied as a gross revenue reduction in test year rates.

2. *Rate of Return Adjustment—Reduced Risk.* The authorized rate of return upon which test year gross revenue

[6] Staff refers to the Utilities Division of the Commission.

requirements are based is reduced in order to recognize the reduction of financial risk resulting from the cash flow generated by the tax savings from accelerated depreciation and ITC on a normalization accounting basis.

3. *Midpoint Flow-Through Applied to a Normalization Rate Base.* In addition to the normalized treatment of deferred tax reserve, one-half of the difference in gross revenue requirements between normalization (for accelerated depreciation) and ratable flow-through (for ITC) and a full flow-through of each is reflected in rate reductions.

4. *Normalization with Amortization of Deferred Taxes.* This is similar to the method of adjusting the expense and rate base for contributions in aid of construction. The gross revenue requirements are reduced by the reduction in rate base in the amount of the average deferred tax reserve for the test year, but the deferred tax reserve is also amortized (using the straight-line depreciation rate) by a sum also reflected in a reduction in gross revenue requirements and rates.

5. *Rate of Return Adjustment—Cost-Free Funds.* This is substantially equivalent to General's no-cost capital proposal.

The City and County of San Francisco's (SF) Proposal

SF recommends full flow-through, or in the alternative, a rate of return reduction contingent upon a favorable IRS ruling on eligibility, but in the event of an unfavorable ruling, rates to be then reset on a full flow-through basis. The purpose of this theory is to provide the companies with an incentive to obtain a favorable tax ruling, or alternatively, to amend the existing law to avoid the loss of eligibility.

The City of Los Angeles's (LA) Proposal

LA recommends a rate of return reduction up to a maximum of two percentage points,[7] while continuing the normalization treatment of tax expense. This reduction is to be quantified after considering three factors:

(1) Analysis of the financial risk reduction of a normalization as compared to a flow-through company due to the greater cash flow generated, the reduction of the need for outside financing, the reduction of the cost of embedded debt, the improvement in interest coverage, and the generally favorable effect on the cost of new capital and evalution of the utility's securities generally. (This position is supported by the city of San Diego.)

(2) The previously found imprudent management in failure to elect accelerated depreciation to avoid rewarding the utilities for their imprudence.

(3) Reflection of the phenomenon of inverse attrition, which is the opposite of the allowance for attrition that the Commission has used in the past as a regulatory tool where there is a projected diminution of the rate of return. Here, since the normalized tax reserve grows at a markedly greater rate than the other components of the utility's operations, the authorized rate of return would be exceeded in subsequent years because no reduction in rate base occurs between test years. The inverse attrition allowance set in the test year will reduce the rate of return in the future. (This is a step beyond the continuous surveillance me-

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[7] For test year 1975-76, the staff calculates that the rate of return for Pacific would be 2.17 percentage points higher on a flow-through basis than on a normalization basis.

thod now in use, which only applies to earnings in excess of the authorized rate of return.)

LA recommends that ITC be treated in the same manner.

Toward Utility Rate Normalization's (TURN) Proposal

Turn proposes another method of compensating for the reduced risk of normalization by reducing the rate of return. It is calculated by discounting to present value the money which is accumulated in the deferred tax reserve and the measurement of that time value upon the rate of return allowed in addition to the normalization treatment. The method also applies to ITC using a three-year forward averaging amount (test year and two following years). In the beginning this method would produce a refund in excess of the refund produced by full flow-through.

OTHER POSITIONS

Citizens Action League (CAL). CAL supports a greater sharing of the benefits of accelerated depreciation with ratepayers than exists under normalization accounting, and urges refunds be paid in cash rather than as a bill credit.

Continental Telephone Company of California. This company would be affected by our decision here only if a refund of toll revenues collected by Pacific should be ordered.

The Los Angeles Urban League. This organization seeks equal opportunities for blacks and other minorities in all sectors of our society and is concerned over a decision adverse to Pacific which would be disastrous to Pacific's minority hiring, firing, and promotion practices under Pacific's scenario of service and construction reductions.

Los Padrinos, Inc. This is a nonprofit charitable and educational corporation of predominantly Spanish-surnamed employees of Pacific. It is also concerned about the

serious economic consequences depicted by Pacific's witnesses and urges the Commission to adopt an alternative which will preserve Pacific's eligibility for tax benefits.

The National Association for the Advancement of Colored People (NAACP). NAACP is a civil rights organization with the principal purpose of eliminating racial discrimination in every facet of American life. It urges the Commission to allow Pacific the full tax advantage of accelerated depreciation and ITC to preserve the employment of ethnic minorities and aid in employing the large number of unemployed black persons.

The Pacific Telephone Employees for Women's Affirmative Action, Southern California. This is an organization dedicated to aiding Pacific in achieving its affirmative action goals relating to women and urges action similar to the other above-mentioned groups.

DISCUSSION

One of the major difficulties in the resolution of these cases is the length of time that has transpired between the onset of the problem and its latest submission for resolution. In Case 1 the court recognized then (in 1971) that one extreme or the other in the solution would be harsh to either the utilities or the ratepayers. That proposition has now been exacerbated by the passage of years and many millions of dollars of increase in the deferred tax reserve. Now, in the event of the loss of eligibility for the tax benefits flowing from accelerated depreciation and ITC, Pacific estimates its total potential tax liability here from 1970 through the end of 1976 at $764 million, while General estimates its comparable liability at $223 million, or together almost $1 billion in potential tax liabilities. This is without regard for any rate refunds, ongoing rate reductions, and other costs that might be attributable to a retroactively assessed tax liability, such as the need for raising additional funds for plant investment, the dete-

rioration in financial position, the necessity for increased interest rates and returns on debt and equity, and a myriad of other problems involved, not the least of which are the staggering rate increases that are foreseeable as the bottom line in such a scenario. We are seeking to resolve this dilemma in a middle ground, perhaps pleasing to no one, but finally disposing of this problem by more suitably leveling the interest of the utilities and the ratekeepers. Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis.

Accelerated Tax Depreciation

The parties recommend various positions which encompass the entire spectrum of possibilities from maintaining the status quo with normalization to a method which would refund more money than would be available under flow-through. While the alternatives submitted are plentiful, all are substantially variations on two themes: (1) reduction of rate of return; and (2) some form of reflecting the increase in the deferred tax reserve in order to further reduce the rate base (the annual adjustment method).

The utilities would prefer to maintain the status quo, though Pacific condescended to advocate what amounts to an annual rate case, merely holding the rate of return and any other test year adjustments constant while delving

into the entire cost of service each year, a solution that will solve nothing while adding to the specter of regulatory lag.

General was somewhat more generous by offering additional variations on the annual adjustment, while offsetting the increased deferred tax reserve with increased federal tax expense.

The staff basically recommended full flow-through but as a concession to compromise supported a rate of return reduction based on reduced risk only for future rates and a refund based on full flow-through for the rates subject to refund. LA recommended a maximum two percentage point rate of return reduction for the current test year 1975-1976 for Pacific, although it supports flow-through as the only proper ratemaking approach.

For General's test year the rate of return difference between flow-through and normalization was .14 percentage points in test year 1970, 1.39 in test year 1974, and 1.58 in test year 1976. (Staff Exhibit 45.) For Pacific, the pertinent years and comparable differences are as follows: Test year 1973, 1.52 percentage points; test year ending June 30, 1976, 2.17. (Staff Exhibit 46.) The flow-through basis always produces a higher rate of return because the greater the dollar amount of depreciation differential is between straightline and accelerated depreciation, the smaller the correlative federal tax expense is for the flow-through company, and the greater the earned rate of return.

While we agree that full flow-through is the proper and best ratemaking method, we shall not consider it further because both Pacific and General would be ineligible for accelerated depreciation and ITC if rates were set on a flow-through basis. We must look to some other alternative, proposed or encompassed in the entire range of possible alternatives.

All the variations on the theme of increasing the deferred tax reserve provide readily estimable items for the purpose of computing the necessary numbers to determine the gross revenue requirements and rates. On the other hand, the reduction in rate of return is subjective, highly judgmental, and most difficult of quantification, as all the parties concede. If we were to adopt reduction in rate of return, what number would we adopt? How is this number to be determined? Is the difference in rate of return because of reduced risk merely a function of the dollar difference, as suggested by LA's witness? (Exhibit 22, page 16.) If not, what other factors are used to compute the actual number? If we adopt reduction in rate of return based on the dollar differences, as computed by the staff, what justification is used to differentiate this return from the return based on normalization accounting? Do we reason that the entire reduction in rate of return is caused by the risk reduction, as we did in D.85627 (Southern California Gas Company)?

In D.83540, the decision on petition for rehearing in D.83162, we stated on page 4: "The impact of normalization upon risk, and hence upon rate of return, was taken into account in the Commission's deliberations and was one of the factors which caused us to reduce the equity return authorized for Pacific below that authorized for other California utilities of similar capital structure. The impact or normalization on Pacific's risk was not specifically discussed because it was not disputed; all parties, including Pacific, conceded that the authorization of normalization reduces risk below that which would otherwise result. This uncontradicted evidence was taken into account in fixing rate of return." To now say that we shall again reduce rate of return in D.83162 when we already conceded that it was taken into account in setting the original rate of return would be unfair as the reduced risk would be reflected twice in rate of return. We believe it fairer to use a variation of the

annual adjustment proposed, which we will call the "averaged annual adjustment".

The theory of this method is simple: Because the increase in the deferred tax reserve is deduced from rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenues will then produce less tax expense since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reduction.

General's expert witness testified (Exhibit 3, page 10): "If the deferred tax reserve is determined as of a time subsequent to the test period, tax expense for ratemaking purposes must be determined as of the same time." This principle is embodied in General's first alternative (pages 13 and 14, above), which remedies the alleged defect of the old pro forma method, which did not take into account tax expense for the same period used to calculate the reserve. (General's opening brief, page 16.) General's opening brief, page 16, describes the methodology, as follows: ". . . the deferred tax reserve is averaged three years into the future in the same fashion as pro forma normalization, and in addition, federal income tax expense is also averaged for the same three-year period by which test period tax expense and rate based is adjusted. The necessary correlation of the reserve and tax expense provided in the cited Treasury Regulation is thereby achieved (Exhibit 3, page 16)." This is exactly the methodology for the averaged annual adjustment.

General believes it fair to assume growth in the tax expense every year. The actual federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it. (Exhibit 36, Pacific; Exhibit 27, General.)[8] TR 1.167(l)-(1)(h)(6) does not discuss rev-

[8] In addition, the effective actual tax rate has been generally declining.

enue growth, nor the direction of federal tax expense, but only the time frame for two specific items. We think it equally fair to assume a tax expense for the averaged annual adjustment that decreases as the deferred tax reserve increases in each year to accurately reflect only the increase in deferred tax reserve in the same period of tax expense. Thus, we will hold constant all items of cost-of-service not directly dependent on the increase in deferred tax reserve. The computation starts with the test year figures. Using the latest available estimates, we will compute the reduction in net revenues resulting from the increased deferred tax reserve in each of the next three years, compute the resulting decrease in tax expense in each corresponding year, then average the deferred tax reserve and federal tax expense for the four-year period. These averaged annual adjustment figures for deferred tax reserve and federal tax expense will then be used in the current test years for the pending rate cases. For past years, the total of the decrease in net revenues and decrease in federal tax expense [9] will be deducted from the gross revenues computed under normalization accounting, and the difference shall be refunded. Tables 1 and 2 (Appendices B and C) show the method and results for Pacific and General, respectively. Total refunds through December 31, 1977 for Pacific are $110,785,000 and for General are $40,230,000. The current rate reduction is $31,609,000 for Pacific and $6,571,000 for General,[10] based on current test years and estimates for three succeeding years. The refund amounts contain interest at the rate of 7 percent per annum through December 31, 1977 from the time the rates were originally authorized and collection began. The deferred tax reserve amounts used are actual through 1976 and estimated thereafter.

[9] A small factor shall be added as appropriate to compensate for decreased uncollectibles and franchise taxes.

[10] This amount may be adjusted for more current estimates in A.55492 for Pacific.

Pacific's opening brief (pages 42 and 43) indicates that cost-of-service must include the total tax expense [11] for the test period and the succeeding "pro forma" priod. This means the tax expense for each of the future years will have to be estimated. While Pacific agrees that the regulations do not cover how tax expense must be estimated, it indicates that the same method used to estimate future deferred tax reserve must be used to estimate future tax expense or the procedure would be suspect and subject to IRS disapproval. No authority is cited nor is any specific method of estimating proposed, nor does the IRC and the treasury regulations direct or discuss the estimating process. We believe our method is direct, simple, and in full compliance with the applicable federal law. Eligibility will be maintained since the federal tax expense for cost-of-service purposes is computed for the same period as the deferred tax reserve. While we agree that it uses a bookkeeping fiction, it is no more fictitious, no more illogical, and no more unreasonable than the fictitious theory of normalization. In *San Francisco v PUC* (1971) 6 C 3d 119, 130-131, the court said "Both of the extreme methods (normalization and flow-through) involve a fictitious charge of federal tax expense. . . Since a fictitious figure must be used under either method it is not improper for the commission to use an additional fictitious factor to limit the harsh results. Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections." We adopt this reasoning here.

The averaged annual adjustment is actually a form of annual ratemaking. It is not objectionable because it uses

[11] General's exception to the Proposed Report makes this same point. Our discussion applies equally to this exception.

assumed constants, as these are used in an ordinary test year projection, whether or not we are considering the deferred tax reserve and the tax expense in an isolated manner. If the test year is 1970 and the rates remain in effect until the next test year, which is 1974, we have assumed that the cost-of-service has remained constant for the years 1971, 1972, and 1973. This may be unrealistic, but clearly permissible under our authority and the law. On a normalization basis, we will do the same. We will compute the deferred tax reserve and the tax expense on a normalized basis for the test year, and thereafter until the next test year those items and all other elements of cost-of-service are deemed constant. We see no difference in taking the deferred tax reserve and computing the tax expense and the rates based on those two items (and their variables) for years subsequent to the test year and averaging them back into the test year. Though the method is different, the principle is identical to the ordinary test year principle. Nor is this subject to the objection that this is a flow-through subterfuge. Everything and every method proposed by any party, including normalization as used by the companies here, is a method of flow-through. Normalization, according to Pacific, saves the ratepayers a great deal of money compared to straight-line depreciation, and there is no question that it does. But it does not approach the only sensible and realistic method of setting rates—using the actual tax expense as the cost-of-service tax expense. The method being adopted here is a more equitable and realistic method of normalization than the other proposals and the best available now.

ITC

While we agree with the Supreme Court that the effect of accelerated depreciation and ITC is identical the laws and regulations respecting them differ substantially. Thus, the specific delineation of permissible ratemaking policies in regard to maintaining ITC eligibility as set forth in IRC

Section 46, supra, requires a ratemaking treatment for ITC differing from that accorded accelerated depreciation.

There is no question that utilities which did not elect accelerated depreciation with flow-through prior to the effective date of TRA were ineligible to elect Option 3 (immediate flow-through of ITC when it became effective in December, 1971. In D.85627 (Southern California Gas Company (SoCal)), we imposed a rate of return reduction because of the reduced risk and increased cash flow generated in part as a result of SoCal's election of Option 2 for the years 1975 and 1976, when ITC was increased for those years from 4 to 10 percent for utility plant additions and from 7 to 10 percent for transmission plant additions.[12] It is our position that ITC eligibility was not affected by D.85627. However, the Internal Revenue Service (IRS), in response to a request from SoCal, issued an alleged ruling (Exhibit 52) of which we were notified by letter dated November 22, 1976. In this alleged ruling the IRS concludes that ITC will not be available to SoCal for federal income tax purposes when the benefits to be derived therefrom are treated for ratemaking purposes in the manner provided in D.85627 (as affirmed by D.86117). Our Supreme Court has granted a writ of review on SoCal's appeal of D.85627 and 86117 and has heard oral argument on the matter. While the IRS ruling is not the final determination of this issue, we believe that a rate of return reduction is not warranted in this proceeding in any event. We also, in this proceeding, reject the concept of a permanent reduction in rate of return for past as well as future rates, as recommended by some of the parties.

We do not believe a rate of return reduction to be any more of a subterfuge for accomplishing flow-through than any of the other methods presented here nor are we reject-

[12] This increase in ITC was extended through 1980 in the bill signed into law on October 4, 1976.

ing it for that reason. In a full rate case, all the elements of cost-of-service are considered in the process of arriving at a reasonable rate of return. Here, all the parties advocating this method base it solely on the number of dollars of desired refund, and not vice versa. In this proceeding, where we are addressing ourselves to changes in the level of ITC which may be expected to occur beyond the test year, we prefer a more precisely ascertainable result.[13] For these reasons we are adopting for the purposes of ITC and eligibility thereunder the only method that appears to encompass all the factors we desire, the annual adjustment. Sometime prior to the first day of each year after (and including) the test year, we shall recalculate the ITC for the coming year on the basis of the best estimates then available and shall adjust the rates accordingly at the beginning of the year to provide for the full year-to-year growth in the annual amount of ratable flow-through (Option 2). The difference in tax expense between that occurring on the test year because of Option 2 and that estimated for the adjustment year would be computed on the most recent estimate for eligible plant additions. The intrastate factor would be applied and the charge would be converted to revenue requirement by the proper net-to-gross multiplier and applied as an adjustment to decision rates for the year following the test year. Thereafter, we shall delete the earliest year and use the next year to establish the tax expense difference, and adjust the then current rates.[14] For Pacific, the refund obligation through December 31, 1977 for ITC is $51,231,000 and the approximate current rate reduction is $23,346,000 (Table 3, Appendix D). For General, the

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[13] This reasoning applied equally to accelerated depreciation.

[14] Annual adjustments may also be implemented when a Commission decision becomes effective after the beginning of the first annual adjustment period. The first annual adjustment will merely be incorporated in any such decision.

comparable figures are $15,649,000 (gross) and $4,771,000 (Table 4, Appendix E).

We are rejecting all the other proposed treatments for varying reasons, principally that they either cause or tend to raise doubts about eligibility, or do not adequately redress the balance between the ratepayers and the utilities.

Imputed Flow-Through of Accelerated Depreciation

In reviewing the record of this proceeding it has come to our attention that certain old vintage plant additions were not previously considered in the ratemaking process. We shall discuss Pacific and General separately.

Pacific

In D.74917 dated November 6, 1968 we imputed flow-through of accelerated tax depreciation for 1967 vintage plant using a 1967 test year. In D.77984 dated November 24, 1970 (test year 1970) the normalization treatment for accelerated depreciation was ordered for Pacific. When this decision was annulled the rates reverted to those set in D.74917 (test year 1967). In D.80347 dated August 8, 1972 rates were increased using 1970 vintage plant additions to determine the flow-through of accelerated depreciation ordered there. The rates set in this final decision were effective until August 17, 1974, the effective date of the rates set in D.83162. The net effect of this history is that no accelerated depreciation for 1968 and 1969 vintage plant additions was ever reflected in Pacific's rates, even though our Supreme Court approved the imputed flow-through of accelerated depreciation.

In Exhibit 32 in A.53587 (and the A.51774 rehearing), this imputation was proposed for the two years in question. We shall adopt this recommendation. Further, we shall continue this imputation through Pacific's test years 1973 in D.83162 and 1974-1975 in D.85287 and shall order here an ongoing reduction in pending A.55492 (test year

1975-1976) for this flow through item. These amounts are as follows:

Flow-Through of 1968 and 1969
Vintage Plant Additions
(Table 5, Appendix F)

(Dollars in Thousands)

D.83162 (Test Year 1973) 8/17/74 to 1/4/76	$24,158
D.85287 (Test Year 1974-75) 1/5/76 to 12/31/77	19,412
	$43,570
Ongoing reduction (TY 1975-76) A.55492	$ 5,539

SUMMARY OF PACIFIC REFUNDS AND
RATE REDUCTIONS THROUGH DECEMBER 31, 1977

(Dollars in Thousands)

REFUNDS

Accelerated Tax Depreciation (Table 1, Appendix B)	$110,785
ITC (Table 3, Appendix D)	51,231
Flow-Through of 1968 and 1969 Vintage (Table 5, Appendix F)	43,570
TOTAL REFUNDS	$205,586

RATE REDUCTIONS (A. 55492)

Accelerated Tax Depreciation (Table 1, Appendix B)	$ 31,609
ITC (Table 3, Appendix D)	23,346
Flow-Through of 1968 and 1969 Vintage (Table 5, Appendix F)	5,539
TOTAL RATE REDUCTIONS	$ 60,494
TOTAL REFUNDS AND RATE REDUCTIONS	$266,080

General

A similar situation exists for General but it is limited to 1969 vintage plant additions. In D.75873 dated July 1, 1969 we imputed flow-through of accelerated depreciation for 1968 vintage plant using a 1968 test year. In D.79367 dated November 22, 1971 increased rates were ordered using the normalization treatment of accelerated depreciation beginning with 1970 vintage plant additions. Thus, 1969 vintage plant additions were never reflected in General's rates, all of which have been subject to refund since D.79367.

In Exhibit 5-R in A.53935 (and the A.51904 rehearing), this imputation was proposed for 1969. We shall adopt this recommendation and shall continue this imputation from December 12, 1971 (the effective date of D.79367) through test years 1970 (D.79367), 1974 (D.83779), and 1976 (D.87505).

However, in Table 6 of Exhibit 2, General claimed credit for refunds and rate reductions already made as a result of the annulment of D.78851 of Pacific.[15] In D.83778 dated November 26, 1974 we said, on page 41:

> "The refunds already made by General are attributable to the annulment of Decision No. 78851 while the settlement revenue losses to General are attributable to the annulment of that decision and also to the difference between Pacific's rates authorized in Decision No. 80347 and Pacific's annulled rates."

Failure to give General credit for these sums would amount to requiring double refunds. Since this would be inequitable, we are offsetting the losses already incurred

[15] This claim was also made in General's exceptions to the Proposed Report.

against the refunds and rate reductions required of General by this decision.[16]

SUMMARY OF GENERAL NET TOTAL REFUNDS AND RATE REDUCTIONS THROUGH DECEMBER 31, 1977

(Dollars in Thousands)

REFUNDS	
Accelerated Tax Depreciation (Table 2, Appendix C)	$34,987
ITC (Table 4, Appendix E)	15,363
Flow-Through of 1969 Vintage (Table 6, Appendix G)	
a. D.79367 (TY 1970) 12/12/71 to 12/20/74	9,244
b. D.83779 (TY 1974) 12/21/74 to 7/17/77	7,245
c. D.87505 (TY 1976) 7/18/77 to 12/31/77	670
TOTAL REFUNDS	$65,440
RATE REDUCTIONS (D.87505)	
Accelerated Tax Depreciation (Table 2, Appendix C)	$ 6,571
ITC (Table 4, Appendix E)	4,771
Flow-Through of 1969 Vintage (Table 6, Appendix G)	1,311
TOTAL RATE REDUCTIONS	12,653
TOTAL REFUNDS AND RATE REDUCTIONS	$78,093

[16] In applying the credit, reductions are treated separately for 1971, 1972, and 1973 (from 1/1/73 to 9/22/73 only) and compared to refunds computed for those years, in accordance with the principle used by General in Exhibit 2, Table 6. Reductions in refunds are made first to the imputed flow-through refunds, then any remaining reduction is credited to ITC, and finally and remaining reduction is credited to accelerated tax depreciation. (See Table 7, Appendix H.)

SERVICE

Pacific has depicted a service and employment scenario of horrendous proportions in the event it loses eligibility for accelerated depreciation and ITC, and assuming a back tax payment of $764 million, rate refunds of $73 million and an ongoing rate reduction of $62.6 million. In 1972 and 1973, however, Pacific refunded $176 million together with a rate reduction of $90 million and had no significant employee layoffs, no deterioration in service and no adverse effects on earnings.

Because the eligibility of both companies is unaffected in our judgment, we foresee no meaningful change in the operations and quality of service, number of employees, level of earnings, impairment of financial integrity, or other deleterious consequences as predicted by Pacific. Thus, the companies are put on notice that any deviation from their current service indices, objectives, standards, and our General Order No. 133 shall be monitored and, when appropriate, punished to the fullest extent of the law. For these purposes, we particularly emphasize Pacific's 1976 Service Objective List admitted as Exhibit 43 in its pending A.55492 as exemplary of the service standards expected, together with the ultimate determination, in the same proceeding, of the acceptable level of held primary orders.

MISCELLANEOUS CONTENTIONS

Pacific and General have discussed many other points, some pertinent, some not. We shall briefly discuss due process, actual results of operations, confiscatory rates, retroactive ratemaking, credit for revenues authorized but uncollected, and settlement adjustments.

Pacific relies heavily on the case of *West Ohio Gas Company (No. 2) v Public Utilities Commission* (1935) 294 US 79. There the regulatory agency had, in setting a rate in 1933, chosen to rely exclusively on data from 1929, ignor-

ing available revenue and expense data from 1930 and 1931. The court said this was an unconstitutional procedure. Our situation here is easily distinguishable, as we are taking into account the actual deferred tax reserve and ITC amounts for the past years and computing the functional variables from that actual number. Our Supreme Court in *Los Angeles v PUC* (1975) 15 C 3d 680, has already found this procedure to be proper since the tax expenses and reserves under accelerated depreciation vary abnormally with respect to the other components of a utility's finances. The court said on page 703, "Simply to recognize this fact is not to deny due process."

Further, the actual results of Pacific's operations indicate a financial picture much brighter than depicted by Pacific. It is true that the dividend on common stock has not been increased since 1961, as Pacific alleges, but that is a management decision which is not directly related to its per share earnings or any other indicia of financial progress. In 1961 Pacific had 104 million common shares outstanding while at the end of 1975 it had over 168 million such shares and contemplates over 181 million at the end of 1976. Thus, the total dividends paid now are approximately two-thirds greater than in 1961, to over $202 million in 1975. Further, the earnings per share increased from $1.46 in 1970 to $1.82 in 1975 and $2.06 in 1976, all on an increased number of outstanding shares. There has been an increase in the number of employees, an increase to earned surplus from 1972 to 1975 of the staggering sum of $245 million, and an increase in construction budget from 1971 to 1974 of $225 million. And this was all accomplished while refunding $176 million with an ongoing rate reduction of $90 million per year. In this be confiscation, let there be more of the same. In view of these facts, Pacific's arguments regarding confiscatory rates are untenable and rejected.

Neither do we agree with Pacific's position that the imposition of a penalty for imprudence would constitute im-

proper retroactive and punitive ratemaking since this procedure has already been approved by the Supreme Court (6 C 3d 119). Penalties for imprudence, like penalties for civil or criminal wrong, have nothing to do with rates; they are punishment. But we are not imposing a penalty here; we are determining the proper basis for setting rates.

Pacific has suggested that it is appropriate, in the event the Commission orders a refund in this matter, to deduct from the amount of refund the revenues previously authorized but not collected because it has failed to earn its authorized rate of return. If rate of return has not been earned, the remedy for that, as clearly set forth by the court in 15 C3 680, is to seek rate relief, which both companies have done and are presently doing. Further, this recommendation would guarantee the authorized rate of return. Because it is axiomatic that this Commission does not guarantee the return, but merely provides an opportunity to earn it, the requested credit would be inapposite.

Since our action will not render Pacific ineligible, we need not answer its argument that this would unduly burden interstate commerce, particularly as no evidence on this point was tendered.

The rates to be filed by the utilities pursuant to this order will, of course, reflect settlement payments between utilities. However, we will not authorize any retroactive settlement adjustments associated with refunds resulting from this order.

Refunds in the Form of Stock

It was suggested in the event a refund was ordered that it be accomplished via the issuance of capital stock of Pacific and General. The companies introduced a great deal of material setting forth the problems involved with this idea. The major potential problems are with the Securities & Exchange Commission, the difficulty of issuing minute fractional shares for small refunds to ratepayers, the large

cost of such a program, and the Commission's authority to order such a securities issue. No party supported this concept in its present form. We shall not order it.

Refunds and Reductions

Refunds in the past have been made in direct proportion to the billing of the various customers without regard to class of service. In this case it was suggested that refunds be made only to residential customers on the theory that since business customers include telephone service cost as part of their cost of doing business, they are being paid by the consumer for the cost of the phone service. A refund theoretically would then create a windfall for the business phone customers since no refunds by the business customers would be made to its customers. It can also be argued, however, that the amount of any refund to the business customer would be used to reduce the cost of business for the period in question and thereby would be reflected in lower or stable prices. In our opinion there is no evidence, one way or the other, in this proceeding to support either view.

Another suggestion was to refund to all customers on a per capita basis, meaning that the total amount of the refund would be divided by the total number of customers of the company and the same dollar amount refund would be given to each customer whether residential or business. Since the number of residential customers is much greater than business customers, and as residential revenues approach 50 percent, it is apparent that individual business customers on average pay much greater monthly revenues to the phone companies than the individual residential customers. This proposal, for example, would have the effect of giving the city of Los Angeles, General Motors, and every individual the same amount of refund. In the case of the residential customers, their refunds might well exceed their monthly bills.

Pacific and General will be directed to file proposed refund plans. Approval, disapproval, or modification of the proposed plans will follow by subsequent Commission order.

The ongoing prospective rate reductions ordered herein shall be reflected in rates for all current subscribers by a uniform proportional reduction in the recurring basic exchange primary service rates. To insure that rates for competitive services are not reduced (since those rates are generally priced as nearly as possible at full cost) we are directing that only rates for basic exchange primary service be reduced. With respect to central office centrex service the reductions shall be made on the trunk rate per station.

IRS Ruling Request

The companies have suggested that any proposed action changing the method of normalization now being used should allow the continuance of existing rates, either by putting the rates aside in a trust fund, as suggested by the Supreme Court, or keeping them subject to refund as at present, until such time as a ruling can be rendered by the IRS regarding the retention of eligibility under the method adopted by this Commission for treating the tax expense problems. This is based on the theory that if the IRS disapproves the proposed treatment the present method of accelerated depreciation shall continue in effect, or another proposed method may be submitted for a ruling. But the companies' requests provide no incentives to obtain an expenditious advance IRS ruling, and might lead to further delay in the implementation of the refunds contemplated in this order. Moreover, General's expert witness Nolan indicated that there are some instances where the IRS will not issue an advance ruling, nor does the IRS necessarily advise in advance that it will not issue such a ruling. The supplicant merely waits and hopes. Nolan also said that the more difficult the problem, the more

likely the IRS is to avoid issuing an advance ruling. We have here a case of first impression under the tax laws, and we think an advance ruling within a reasonable time is not probable. Moreover, the opportunities for such action by the utilities have been ample in the past, yet they took no such action. For these reasons we think that their proposals are inappropriate.

Exceptions to Proposed Report

We shall discuss here, where necessary, the exceptions that have not been discussed elsewhere in this opinion.

Pacific

Pacific's exceptions generally fall into two categories:

1. Since D.83162 was issued in August 1974, its earnings have been below the authorized rate of return and it is improper to order refunds and rate reductions in such circumstances. We have already discussed this point elsewhere, and concluded otherwise. There is nothing sufficiently meritorious in Pacific's exceptions in this area that have not been raised, discussed, and disposed of by this Commission, or our Supreme Court.

2. Pacific's eligibility for accelerated tax depreciation and ITC is endangered by the proposed treatment of these benefits.

(a) *Accelerated Tax Depreciation.* Pacific complains of the use of recorded data for historical periods, but in its brief cited the *West Ohio Gas* case (supra) as requiring the recognition of such data. Its position is inconsistent and varies with the direction the wind is blowing. Further, there is no prohibition in proper ratemaking or the IRC sections in question which bar this procedure.

Pacific also complains of the failure to use the pro rata requirements in Treasury Regulation 1.167(*l*)-1(h)(6)(ii). It overlooks the discussion on page 3 of Exhibit 16 spon-

sored by staff witness John Quinley, where the use of the pro rata percentage of 46.33 is shown. Mr. Quinley explains the offsetting working cash adjustment which produces a combined effect of 50 percent as the proper figure to be used in determining the average deferred tax reserve and its ultimate revenue effect. Footnote 4, Table 1, Exhibit 16, reflects this combined effect, as does Footnote 4, Table 1, Exhibit 10-A (sponsored by Pacific), which uses the identical percentage as its Table 1 is identical to Table 1 of Exhibit 16.

The other exceptions with respect to accelerated depreciation have been either mentioned or explained elsewhere and merit no further discussion.

(b) *Investment Tax Credit.* Pacific cites proposed treasury regulations allegedly relating to its interpretation of our ITC treatment. These proposals in our judgment do not effect the validity of our treatment and have no force or effect, in any event, being mere proposals. We reiterate that our treatment of ITC is akin to an annual ratemaking procedure. We see nothing in law or logic that prohibits this treatment.

General

The thrust of General's exceptions relates to the alleged ineligibility for accelerated depreciation which would occur as a result of the treatment of that subject in the Proposed Report. General alleges that the *total* tax expense must be considered for the same period for which the deferred tax reserve is estimated, and the Proposed Report considers only the reduction in tax expenses. This is not the case, as the reduction in tax expense for years after the test year is used to reduce the *test year tax expense* used in the succeeding year. The effect is to reduce each succeeding year's tax expense, but the entire tax expense is used for the appropriate period. General also alleges that the proposed method is exactly like the old pro forma method, except

for the time period. That is correct, because the failure to consider the deferred tax reserve for the same period as the tax expense is the alleged defect of the old pro forma method regarding eligibility. The Averaged Annual Adjustment remedies this defect by considering the two required items separately for the same period. While the effect is the same as pro forma, we are specifically complying with the existing tax laws by using a proper method to compute the revenue requirement. It must also be noted that this method complies exactly with the method (though not the assumptions) recommended by General and its witnesses.

We have already discussed and decided the other major exception: the double refund effect for revenues authorized but not collected because of Pacific's prior refunds.

There is no retroactive ratemaking involved here since all General's rates since November 22, 1971 have been subject to refund. The fact that ITC was not previously considered does not make it res adjudicata, nor does it prevent this Commission from reflecting its effect where possible. That is what we are doing by this decision.

LA

LA objects to the failure of the Proposed Report to decide the constitutionality of the relevant tax laws under the Tenth Amendment to the U.S. Constitution. We already decided that question in the affirmative in D.83778 and see no reason to go into the matter again.

We have previously discussed, directly or indirectly, all the other matters raised in LA's exceptions.

TURN

TURN filed two exceptions, one relating to its proposed method of determining the amount of refunds (discussed earlier), and the other relating to the effective date of the Proposed Report. We see no need to consider its exceptions.

EPILOGUE

We desire to discuss the wisdom of using the tax laws for the purpose of providing a capital subsidy (in this instance, phantom taxes) from the taxpayers (in this instance, the ratepayers) to a special interest group (in this instance, state-regulated utilities). This occurs because every dollar of taxes that the utilities pay is obtained in rates from the ratepayer, even when the utilities can defer, and perhaps never pay the taxes collected in rates. The regulators must essentially order two dollars to be paid to the utility by the ratepayer for each dollar in taxes avowedly to be paid by the utility. This seems to us to be a wasteful use of resources as well as a legally sanctioned subsidy to the utility from the ratepayer without the latter's consent. The money is not being contributed by investors in the usual manner, but is being contributed in the form of rates by the ratepayer on a two-for-one basis and not on a one-for-one basis, as it the case for traditional investment capital. The funds are being obtained from the ratepayers under the guise of taxes, while Congress has decreed that the money so collected as taxes need not be used as taxes by the utilities, but may be used by the utilities for whatever purposes they desire. There is no restriction on the use of these funds in the tax laws. The taxes collected, but not paid, in essence amount to a direct capital subsidy which the utilities may use as unrestricted capital. Nothing is paid to the ratepayers for this investment use of the ratepayers' money as would be paid to traditional investors. Thus, this is free capital, and this is occurring in a free enterprise system which traditionally rewards venture and investment capital!! Here, the converse is true. The ratepayers are actually being penalized instead of being compensated for this subsidy. Their money is being involuntarily contributed on a two-for-one basis, and no return is forthcoming on any basis. We think this is grossly unfair and should be more forcefully presented by the utilities, by the regulatory agencies, and by con-

sumer organizations. Congress has created a situation where in California both the utilities and the ratepayers feel they are being whipsawed by these tax laws and the actions of this Commission in attempting to be fair to all sides. This Commission believes that it has a legal duty to balance the interests of the utilities and the ratepayers and is attempting to do so, but finds itself more frequently hamstrung by the actions of Congress where it appears that the interests of the utility ratepayers are not adequately considered, for whatever reason.

What this Commission proposes and strongly supports, in lieu of this hidden subsidy and no-cost capital contribution to the utilities by the ratepayers (we mean at no cost to the utilities), is the elimination of the income tax upon regulated utilities to be replaced with a gross receipts tax (or, for energy and water utilities, a per unit of consumption tax), as a surcharge to all billings paid by the ratepayers, to be collected by the utilities and paid directly to the IRS. This surcharge would be indicated as such on the utility bills and would not be included in the utility cost-of-service. It could easily be structured to provide revenues to the treasury equivalent to that now being *paid* as income taxes by the utilities. It would eliminate the ratepayers' involuntary and hidden subsidy to the utilities because what they pay in gross receipts tax is what the IRS gets on a dollar-for-dollar basis. If the utilities desire to obtain funds from the ratepayers for the purpose of expansion and investment, let it be done forthrightly by direct subsidy so the ratepayers will have knowledge and the opportunity for input. Let the ratepayers share in whatever benefits might accrue to the utility as the result of any such investment by the ratepayers. We see no reason why the ratepayers, in their role of capital investors, should not share in the fruits of their investment. We believe the tax laws are not the proper medium for the creation of involuntary investment capital. Tax law gimmickry should not tilt or distort the balance necessary between state-regulated utilities and ratepayers.

The gross receipts tax would simplify the job of Congress in levying taxes and simplify the job of the regulatory agencies in setting rates, while preserving the rights of both the utility and the ratepayers. It would create faster rate relief on the part of regulatory agencies and maintain the utilities on a solid financial basis, instead of requiring everyone involved in setting rates to go through a series of contortions and distortions to attempt to comply with or legally avoid the effect of the existing tax laws and the concommitant uncertainty and delays.

Findings

1. Pacific and General were imprudent in failing to select accelerated depreciation when that option was available under the federal tax laws. This imprudence denied the companies the option to elect flow-through accounting for ITC and accelerated depreciation purposes.

2. Flow-through of the tax benefits accruing under accelerated depreciation and ITC is the best method of handling these benefits for the purpose of balancing the interest of the ratepayers and the companies for ratemaking purposes.

3. Pacific and General are ineligible to elect flow-through accounting for accelerated depreciation and ITC for ratemaking purposes pursuant to IRC Section 167, et seq. and Treasury Regulation 1.167, et seq. Normalization accounting is the most appropriate method available to Pacific and General. Under the normalization method we are adopting for ratemaking purposes, tax depreciation expense for ratemaking purposes will be computed on a straight-line basis while federal taxes will be computed on an accelerated depreciation basis. The difference between the two tax computations will be accounted for in a deferred tax reserve. The average sum of the test year deferred tax reserve and the deferred tax reserve for the

three next subsequent years shall be deducted from rate base in the test year. As a result of each of the deductions from rate base federal tax expense will be recomputed on the same basis in the test year for the test year and the three corresponding subsequent years, thus matching the estimated tax deferral amount for each period with the estimated federal tax expense for the same period. This method complies with Treasury Regulation 1.167(*l*)-(1)(h)(6) and is normalization accounting.

4. For ITC we shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of ITC estimated for the next immediate future calendar year as compared to the last test year (or last preceding year), and recomputing federal tax expense and gross revenue requirements based on that new estimate for each year between rate cases. This method complies with the requirements of ratable (service life) flow-through selected by the utilities under IRC Section 46.

5. The methods described in Findings 3 and 4 are an attempt to more accurately reflect in rates the abnormal growth in these reserves compared to the other components of cost-of-service used in computing rates.

6. The methods adopted in this order as described in Findings 3 and 4 comply with the mandate of the California Supreme Court set forth in *City of Los Angeles v Public Utilities Commission* (1975) 15 C 3d 680.

7. The methods described in Findings 3 and 4 fairly balance the interests of the ratepayers and the utilities and avoid harsh results to either as a result of the tax benefits accruing under accelerated depreciation and ITC.

8. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 3 for accelerated depreciation is $110,785,000, including interest at 7 per-

cent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 1. The current rate reduction under this method is $31,609,000.

9. The gross amount to be refunded by General to its ratepayers under the method described in Finding 3 for accelerated depreciation is $40,230,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Tables 2 and 7. The current rate reduction under this method is $6,571,000.

10. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 4 for ITC is $51,231,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 3. The current rate reduction under this method is $23,346,000.

11. The gross amount to be refunded by General to its ratepayers under the method described in Finding 4 for ITC is $15,649,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 4. The current rate reduction under this method is $4,771,000.

12. The maintenance of eligibility under the federal tax laws to allow Pacific and General to use accelerated depreciation and ITC is beneficial to both the ratepayers and the utilities and is an important goal of this Commission in this decision.

13. It is reasonable to order a uniform proportional reduction in the recurring basic exchange primary service rates. With respect to central office centrex service it is reasonable to make the reductions on the trunk rate per station.

14. It is reasonable to impute flow-through of 1968 and 1969 vintage plant additions for Pacific and 1969 vintage

plant additions for General, as the Supreme Court has previously approved this procedure in *San Francisco v. PUC* (1971) 6 C 3 119, and accelerated depreciation of these vintages has never been reflected in rates.

15. A gross receipts tax surcharge would abolish the "two-for-one" collection of income taxes from the ratepayers in rate setting for utilities and would allow lower utility rates since the gross receipts tax would allow a dollar-for-dollar collection of taxes *paid* by the utilities to the federal government.

16. As long as plant investment of the utility continues to expand, the deferred tax reserve is actually a tax saving and not a tax deferral.

17. It is unfair and unreasonable to use the tax laws to create investment dollars flowing from the ratepayers to the utilities on which the ratepayers do not receive any return.

18. The gross receipts tax surcharge would eliminate the involuntary capital contribution incurred by the ratepayers and would abolish the windfall to the utilities by allowing them to collect taxes from the ratepayers which they may never have to pay.

19. The investment tax credit is a tax saving and not a tax deferral.

20. A gross receipts tax surcharge will prevent the distortion of the tax laws to create subsidies from the ratepayers to the utilities in the setting of rates.

21. In computing the refunds and rate reductions computed herein, this Commission has used recorded figures, where available, for the periods in question.

22. The reduction and refunds of rates authorized by this decision are justified and reasonable, and the present rates as they differ from those prescribed therein, are for the future unjust and unreasonable.

23. No revenue adjustments for settlements by Pacific and General with interconnecting carriers will be allowed for the refund period.

24. The amount to be refunded by Pacific to its ratepayers pursuant to Finding 14 is $43,570,000, including interest at 7 percent per annum from the date of the respective order entered from which refunds are being required, as set forth in Appendix F. The current rate reduction under this method is $5,539,000.

25. Because of revenues authorized, but not collected, General is entitled to credit for certain sums refunded and lower rates set due to *San Francisco v PUC* (1971) 6 C 3 119 and D.78851 of Pacific. It is reasonable to offset these amounts against the other refunds required herein, on an annual basis only, first reducing the imputed flow-through of accelerated depreciation under Finding 14, then the ITC refund, and lastly, the accelerated tax depreciation refund.

26. The net amount to be refunded by General to its taxpayers, pursuant to Findings 14 and 25, is $17,159,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Appendix G. The current rate reduction under this method is $1,311,000.

27. As a result of Finding 25, the refunds due from General, pursuant to Findings 9 and 11, are reduced to the net sums of $34,453,000 (Finding 9) and $13,828,000 (Finding 11).

28. The total net refunds due from Pacific and General, and the total current and/or ongoing rate reductions required respectively, are summarized in the tables on page 32 (for Pacific) and page 34 (for General).

Conclusions

1. The methods described in Findings 3 and 4 maintain the eligibility of the utilities to use accelerated depreciation

and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General.

2. This Commission does not guarantee the utility the rate of return authorized in rate proceedings, but merely provides an opportunity to earn that return.

3. The method described in Finding 3 for accelerated depreciation for Pacific and General is a normalization method of accounting.

4. The method contained in Finding 4 for ITC complies with the ratable (service life) flow-through option of ITC under IRC Section 46.

5. The imputation of flow-through of the accelerated tax depreciation benefits for 1968 and 1969 vintage plant additions for Pacific and 1969 vintage plant additions for General is a proper ratemaking procedure and does not affect eligibility under the TRA of 1969.

6. The rates being set herein are not confiscatory.

7. The offset allowed General due to the revenues authorized, but not realized, is a proper ratemaking procedure.

8. There is no retroactive ratemaking ordered in this decision.

Order

It Is Ordered that:

1. The Pacific Telephone and Telegraph Company shall refund the sum of $205,586,000 (computed as of December 31, 1977), being the total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and accelerated depreciation for 1968 and 1969 vintage plant addition on a flow-through basis, as determined herein pursuant to Findings 3, 4, and 14. This

amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

2. General Telephone Company of California shall refund the sum of $65,440,000 (computed as of December 31, 1977), being the net total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined herein pursuant to Findings 3, 4, 14, and 25. This amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

3. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file refund plans for all current (at the time of filing of the plan) subscribers. This plan shall be filed within thirty days after the effective date of this order. This plan must be approved by an order or resolution of the Commission.

4. The methods described in Findings 3, 4, and 14 shall be applied to all future rates of The Pacific Telephone and Telegraph and General Telephone Company of California.

5. The filings required for the continuous surveillance of earned rate of return as previously ordered in D.83540 and D.83778 are no longer required.

6. The Pacific Telephone and Telegraph Company shall reduce current rates by the sum of $60,494,000 (computed as of December 31, 1977), being the total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and accelerated depreciation for 1968 and 1969 vintage plant additions on a flow-through

basis, as determined herein pursuant to Findings 3, 4, and 14.

7. General Telephone Company of California shall reduce current rates by the sum of $12,653,000 (computed as of December 31, 1977), being the net total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined pursuant to Findings 3, 4, 14, and 25.

8. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file tariffs reflecting such reductions on a uniform proportional basis on recurring basic exchange primary service rates, and with respect to central office centrex service the reductions shall be made on the trunk rate per station. Such tariffs shall be filed within thirty days after the effective date of this order and shall not become effective until approved by order or resolution of this Commission.

9. Pacific and General shall not recompute intercompany EAS or other settlement amounts between themselves or with other independent companies as a result of the refunds or rate adjustments ordered herein except for busniess done on or after the effective date of this order.

10. In the event the refund plans and tariffs required to be filed by this order are effective after December 31, 1977, the amounts shown in Ordering Paragraphs 1, 2, 6, and 7 shall be recomputed to the appropriate effective date of the refund plan or tariff filing, with interest as computed in Ordering Paragraphs 1 and 2.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 13th day of September, 1977.

ROBERT BATINOVICH
President

RICHARD D. GRAVELLE

CLAIRE T. DEDRICK
Commissioners

I will file a written dissent.
/s/ VERNON L. STURGEON
Commissioner

I will file a dissent.
/s/ WILLIAM SYMONS, JR.
Commissioner

I will file a concurrence.
/s/ RICHARD D. GRAVELLE

CERTIFIED AS A TRUE COPY
OF THE ORIGINAL

/s/ H. L. FARMER

Assistant Executive Director
Public Utilities Commission
State of California

Appendix A

List of Appearances

Applicants: Robert M. Ralls and *Robert Dalenberg,* Attorneys at Law, for The Pacific Telephone and Telegraph Company; *John Robert Jones, A. M. Hart,* and H. Ralph Snyder, Jr., Attorneys at Law, for General Telephone Company of California.

Interested Parties: Thomas M. O'Connor, City Attorney, and *Robert Laughead,* for City and County of San Francisco; Robert W. Russell and *Manuel Kroman,* for Department of Public Utilities & Transportation, City of Los Angeles; *George R. Gilmour,* Attorney at Law, for TURN; *James F. Crafts, Jr.,* Attorney at Law, and *Del Williams,* for Continental Telephone Company; *Louis Possner,* for City of Long Beach; John W. Witt, City Attorney, by *William S. Shaffran,* Deputy City Attorney, for City of San Diego; *Alexander Googooian,* City Attorney, for City of Bellflower; Burt Pines, City Attorney, by *Leonard L. Snaider,* Deputy City Attorney, for City of Los Angeles; *Jack Krinsky,* for Ad Visor, Inc.; *Dina G. Beaumont,* for Communications Workers of America; *Thelma Garcia,* for Pacific Telephone Women Employees for Affirmative Action; *Joseph J. Salazar* for Los Padrinos, Inc.; *William M. Bennett,* attorney at law, for Consumers Arise Now, and himself; *Diamantes P. Katsikaris,* for Independent Taxpayers Union of California, Inc.; *Timothy J. Sampson,* for Citizens Action League; and John Mack, by *Ballard W. Brooks,* for Los Angeles Urban League.

Commission Staff: *Timothy Treacy,* Attorney at Law, *J. D. Quinley,* and *K. K. Chew.*

Appendix B
Page 1 of 2

TABLE 1

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

				Net Revenue Reduction						Refunds by Decision and Year's Rates Effective	
Test Year	Depreciation Differential [1]	Federal Tax Effect [1]	Average Reserve for Deferred Taxes [1]	Normalization [2]	Average Annual Adjustment [3]	Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Normalization [7]	Year	Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
					(DOLLARS IN THOUSANDS)						
1973	$148,963	$ 71,502	$136,787	$12,106	$24,418	$12,312	$11,364	$480	$24,156	1974	$ 11,501 [9]
										1975	30,623 [9]
										1976	356 [9]
1974-5	207,825 [12]	99,756	267,925 [12]	23,711	38,687	14,976	13,823	644	29,443	1976	33,836 [10]
										1977	34,469 [10]
							Total Refunds Through December 31,			1977	$110,785
1975-6	235,807 [12]	113,187	374,396 [12]	33,134	49,212	16,078	14,840	691	31,609	1978	31,609 [11]
					Annual Ongoing Reduction in Excess of Normalization						$ 31,609

TABLE 1

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

INTRASTATE OPERATIONS

[1] Exhibit 10-A, Table 1, Columns (A) and (D). Tax at 48% of Column (A).

[2] Exhibit 10-A, Table 2, Normalization ÷ NTG (1.962 for 1973 and 1.966 for other test periods).

[3] Exhibit 16-A, Table 2-A, Column (B) ÷ NTG.

[4] Column (E) minus Column (D).

[5] Column (F) × .92307 [(F) × .48/1 — .48].

[6] **Effects of state income tax and uncollectibles (.039 × Col. (F) for T.Y. 1973 and .043 × Col. (F) for T.Y. 1974-75 and 1975-76).**

[7] (F) + (G) + (H).

[8] **Col. (I) adjusted as per Exhibit 34, page 4 and Exhibit 41, Interest added at the rate of 7% per year for 1974-77.**

[9] **D.83162 rates effective 8-17-74 to 1-4-76.**

[10] **D.85287 rates effective 1-5-76.**

[11] **A.55492 test year data adjusted to most recent estimates.**

[12] **Average of two calendar years.**

Appendix C

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TABLE 2

GENERAL TELEPHONE COMPANY OF CALIFORNIA INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

				Net Revenue Reduction						Refunds by Decision and Year's Rates Effective	
Test Year	Depreciation Differential [1]	Federal Tax Effect [1]	Average Reserve for Deferred Taxes [1]	Normalization [2]	Average Annual Adjustment [3]	Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Normalization [7]	Year	Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
				(DOLLARS IN THOUSANDS)							
1970	$ 3,565	$ 1,711	$ 856	$ 71	$ 1,621	$1,550	$1,431	$255	$3,236	—	—
										1971	$ — [9,12]
										1972	— [9,12]
										1973	5,398 [9]
										1974	5,203 [9]
1974	45,881	22,023	65,669	5,812	8,797	2,985	2,755	594	6,334	1974	230 [10]
										1975	7,986 [10]
										1976	8,052 [10]
										1977	4,255 [10]
1976	47,519	22,809	110,507	9,780	12,865	3,085	2,848	638	6,571	1977	3,329 [11]
						Total Refunds Through December 31,				1977	$34,453
										1978	6,571 [11]
				Annual Ongoing Reduction in Excess of Normalization							$ 6,571

TABLE 2

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA

INTRASTATE OPERATIONS

[1] Exhibit 2, Table 1, Columns (A), (B), and (D).

[2] Exhibit 2, Table 2, Normalization ÷ NTG (2.087 for T.Y. 1970 and 2.113 for T.Y. 1974 and 1976).

[3] Exhibit 6-A, Table 2-A, Column (B) ÷ NTG.

[4] Column (E) minus Column (D).

[5] Column (F) × .92037 [(F) × .48/1 — .48].

[6] Effects of state income tax and uncollectibles (.1645 × Col. (F) for T.Y. 1970, .1990 × Col. (F) for T.Y. 1974 and .20695 × Col. (F) for T.Y. 1976).

[7] (F) + (G) + (H).

[8] Column (I) adjusted as per Exhibit 25, Table A-A-2. Interest added at the rate of 7% per year for 1971-77.

[9] D.79367 rates effective 12-12-71 to 12-20-74.

[10] D.83779 rates effective 12-21-74 to 7-17-77.

[11] D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

[12] Adjustments for revenues not collected are shown on Table 7.

Appendix D

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TABLE 3

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY INTRASTATE OPERATIONS

COMPUTATION OF REFUNDS AND 1978 REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

Test Year (Adjustment Year)	Investment Credit Realized [1]	Net Revenue Reduction: Service Life Flow-Through [2]	Net Revenue Reduction: Annual Adjustment [3]	Net Revenue Reduction: Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Service Life Flow-Through [7]	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
				(DOLLARS IN THOUSANDS)					
1973	$22,028	$ 3,249	$ 3,249	$ —	$ —	$ —	$ —	—	$ —
(1974)	24,901	3,249	4,805	1,556	1,437	60	3,053	1974	1,411 [9]
(1975)	62,157	3,249	9,025	5,776	5,332	225	11,333	1975	13,302 [9]
(1976)	65,983	3,249	13,315	10,066	9,291	392	19,749	1976	245 [9]
1974-75	43,529 [12]	6,915 [12]	6,915 [12]	—	—	—	—		
(1976)	65,983	6,915	13,315	6,400	5,907	275	12,582	1976	13,611 [10]
(1977)	71,965	6,915	17,994	11,079	10,226	476	21,781	1977	22,662 [10]
					Total Refunds Through December 31,			1977	$51,231
1975-76	64,070 [12]	11,170 [13]	11,170 [12]	—	—	—	—		
(1977)	71,965	11,170 [13]	17,994 [13]	6,824	6,299	293	13,416	1978	23,346 [11]
(1978)	77,683	11,170	23,045	11,875	10,960	511	23,346		
				Year 1978 Reduction in Excess of Service Life Flow-Through					$23,346

TABLE 3

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

INTRASTATE OPERATIONS

[1] Exhibit 10-A, Table 3, Column (A).

[2] Exhibit 10-A, Table 3, Column (D).

[3] Exhibit 10-A, Table 3, Column (D) in adjustment year.

[4] Column (C) minus Column (B). Note duplication of amounts for 1974, 1975, and 1976.

[5] Column (D) $\times$ .92307 [(D $\times$ .48/1 — .48].

[6] Effects of state income tax and uncollectibles (.039 $\times$ Col. (D) for T.Y. 1973 and .043 $\times$ Col .(D) for T.Y. 1974-75 and 1975-76).

[7] Columns (D) + (E) + (F).

[8] Column (G) adjusted as per Exhibit 40, Computation Method 2. Interest added at the rate of 7% per year for 1974-77.

[9] D.83162 rates effective 8-17-74 to 1-4-76.

[10] D.85287 rates effective 1-5-76. One-half 1977 included.

[11] A.55492 test year data adjusted to most recent estimates. 1978 reduction, Column (G).

[12] Average of two calendar years.

[13] Adjusted as 10/4 times amounts shown in Exhibit 10-A, Table 3 for 1977 in order to approximately reflect the 10% Investment Credit available under the Tax Reform Act of 1976.

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TABLE 4

GENERAL TELEPHONE COMPANY OF CALIFORNIA INTRASTATE OPERATIONS

COMPUTATION OF REFUNDS AND 1978 REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

(DOLLARS IN THOUSANDS)

Test Year (Adjustment Year)	Investment Credit Realized [1]	Net Revenue Reduction: Service Life Flow-Through [2]	Net Revenue Reduction: Annual Adjustment [3]	Net Revenue Reduction: Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Service Life Flow-Through [7]	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
1970	—	—	—	—	—	—	—	—	—
(1971)	$ 2,802	$ —	$ 200	$ 200	$ 185	$ 33	$ 418	1971	$ — [9,13]
(1972)	5,119	—	420	420	388	69	877	1972	— [9,13]
(1973)	4,477	—	718	718	663	118	1,499	1973	1,520 [9,13]
(1974)	5,006	—	1,052	1,052	971	173	2,196	1974	2,664 [9]
1974	5,006	1,052	1,052	—	—	—	—	—	—
(1975)	9,845	1,052	1,708	656	605	131	1,392	1975	1,632 [10]
(1976)	12,267	1,052	2,526	1,474	1,360	294	3,128	1976	3,428 [10]
(1977)	20,093	1,052	3,866	2,814	2,597	561	5,972	1977	3,267 [10]
1976	12,267	2,526	2,526	—	—	—	—	—	—
(1977)	20,093 [12]	2,526 [12]	3,866 [12]	1,340	1,237	277	2,854	1977	1,317 [11]
Total Refunds Through December 31, 1977									$13,828
(1978)	13,495	2,526	4,766	2,240	2,067	464	4,771	1978	4,771 [11]
Year 1978 Reduction in Excess of Service Life Flow-Through									4,771

TABLE 4

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA

INTRASTATE OPERATIONS

[1] Exhibit 2, Table 3, Column (A). Note duplication of amounts for 1974 and 1976.

[2] Exhibit 6, Table 3, Column (D).

[3] Exhibit 6, Table 3, Column (D) in adjustment year.

[4] Column (C) minus Column (B).

[5] Column (D) $\times$ .92307 [(D) $\times$ .48/1 — .48].

[6] Effects of state income tax and uncollectibles. (.1645 $\times$ Col. (D) for T.Y. 1970 and .1990 $\times$ Col. (D) for T.Y. 1974 and .20695 $\times$ Col. D for T.Y. 1976).

[7] Columns (D) + (E) + (F).

[8] Column (G) adjusted as per Exhibit 25, Table 8-A. Interest added at the rate of 7% per year for 1971-77.

[9] D.79367 rates effective 12-12-71 to 12-20-74.

[10] D.83779 rates effective 12-21-74 to 7-17-77.

[11] D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

[12] Adjusted as 10/4 times amounts shown in Exhibit 6, Table 3 for 1977 in order to approximately reflect the 10% investment credit under the Tax Reform Act of 1976.

[13] Adjustments for revenues not collected are shown on Table 7.

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TABLE 5

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO IMPUTED FLOW-THROUGH OF ACCELERATED TAX DEPRECIATION FOR VINTAGE YEAR 1968 AND 1969 PLANT ADDITIONS

Test Year	Federal Tax Effect of Accelerated Tax Depreciation—First Year 1970 [1]	1968 [2]	Additional Net Revenue Reduction Vintage Year 1968-1969 Additions [3]	Federal Income Tax Reduction [4]	Other Gross Revenue Effects [5]	Additional Gross Revenue Reduction [6]	Refunds by Decision and Year's Rates Effective Year	Refund [7]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
			(DOLLARS IN THOUSANDS)					
1973	$43,131	$50,132	$7,001	$6,462	$273	$13,736	1974	$ 6,540[8]
							1975	17,415[8]
							1976	203[8]
1974-5	57,103	61,359	4,256	3,929	183	8,368	1976	9,616[9]
							1977	9,796[9]
				Total Refunds Through December 31,			1977	$43,570
1975-6	65,782	68,599	2,817	2,600	122	5,539	1978	5,539[10]
						Annual Ongoing Reduction		$ 5,539

TABLE 5

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

INTRASTATE OPERATIONS

[1] Exhibit 32 in A.53587, Table II, Column (a), Tax Depreciation × 48%. For fiscal years, use average of calendar years.

[2] Exhibit 32 in A.53587, Table II-A, Column (a), Tax Depreciation × 48%. For fiscal years, use average of calendar years.

[3] Column (B) minus Column (A).

[4] Column (C) × .92307 ((C) × .48/1 — .48).

[5] Effects of state income tax and uncollectibles (.039 × Col. (C) for T.Y. 1973 and .043 × Col. (C) for T.Y. 1974-75 and 1975-76).

[6] (C) + (D) + (E).

[7] Col. (I) adjusted as per Exhibit 34, page 4 and Exhibit 41. Interest added at the rate of 7% per year for 1974-77.

[8] D.83162 rates effective 8-17-74 to 1-4-76.

[9] D.85287 rates effective 1-5-76.

[10] A.55492 test year data adjusted to most recent estimates.

[11] Average of two calendar years.

Appendix G

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TABLE 6

GENERAL TELEPHONE COMPANY OF CALIFORNIA INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO IMPUTED FLOW-THROUGH OF ACCELERATED TAX DEPRECIATION FOR VINTAGE YEAR 1969 PLANT ADDITIONS

Test Year	Federal Tax Effect of Accelerated Tax Depreciation—First Year 1970 [1]	Federal Tax Effect of Accelerated Tax Depreciation—First Year 1969 [2]	Additional Net Revenue Reduction Vintage Year 1969 Additions [3]	Federal Income Tax Reduction [4]	Other Gross Revenue Effects [5]	Additional Gross Revenue Reduction [6]	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund [7]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
			(DOLLARS IN THOUSANDS)					
1970	$ 1,811	$ 3,963	$2,152	$1,986	$353	$4,491	—	—
							1971	[8,11]
							1972	[8,11]
							1973	$ 2,015 [8,11]
							1974	7,229 [8]
1974	11,001	12,055	1,054	973	209	2,236	1974	81 [9]
							1975	2,819 [9]
							1976	2,843 [9]
							1977	1,502 [9]
1976	13,789	14,410	621	573	128	1,322	1977	670 [10]
				Total Refunds Through December 31,			1977	$17,159
							1978	1,311 [10]
						Annual Ongoing Reduction		$ 1,311

TABLE 6

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA

INTRASTATE OPERATIONS

[1] Exhibit 5-R in A.53935 and A.51904 Rehearing, Table I, Column (a) Tax Depreciation × 48% × intrastate factors of .891 for T.Y. 1970, .873 for T.Y. 1974, and .855 for T.Y. 1976.

[2] Exhibit 5-R, Table I-A, Column (a), Tax Depreciation × 48% × intrastate factors as in Footnote 1, above.

[3] Column (B) minus Column (A).

[4] Column (C) × .92307 ((C) × .48/1 — .48).

[5] Effects of state income tax and uncollectibles (.1645 × Col. (C) for T. Y. 1970, .1990 × Col. (C) for T.Y. 1974, and .20695 × Col. (C) for T.Y. 1976).

[6] (C) + (D) + (E).

[7] Column (H) adjusted as per Exhibit 25, Table A-A-2. Interest added at the rate of 7% per year for 1971-77.

[8] D.79367 rates effective 12-12-71 to 12-20-74.

[9] D.83779 rates effective 12-21-74 to 7-17-77.

[10] D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

[11] Adjustments for revenues not collected are shown on Table 7.

Appendix H

TABLE 7

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

ADJUSTMENTS TO TABLES 2, 4, AND 6 FOR REVENUES NOT COLLECTED

Line No.	Item	Gross Revenue Reductions 12-12-71 to 12-31-71	1972	1-1-73 to 9-22-73
		(A)	(B)	(C)
		(Dollars in Thousands)		
1	Total Revenues Not Collected [1]	$ 846	$12,601	$4,372
2	Line 1 Adjusted to 12-31-77 Refund Levels [2]	1,313	18,889	5,963
	Refund Offset by Line 2			
3	Imputed Flow-Through	377	7,616	5,476
4	Investment Tax Credit	35	1,299	487
5	Liberalized Tax Depreciation	291	5,486	—
6	Remaining Revenues Not Collected [3]	393	2,994	—

[1] Exhibit 2, Table 6, line 15 (adjusted for D.83778 refunds).

[2] Adjusted by including interest to match refund amounts.

[3] Line 2, less lines 4, 5, and 6, divided by interest factor.

COMMISSIONER RICHARD D. GRAVELLE, CONCURRING.

COMMISSIONER CLAIRE T. DEDRICK, CONCURRING.

We concur.

Today's decision, while attributed to this Commission, is not really ours. We are merely the instrument of delivery. This decision was spawned by the Bell System; nurtured by Congress; brought through adolescence by the efforts of our staff, the cities of San Francisco, Los Angeles, San Diego, and TURN; shaped into maturity by the California Supreme Court; and finally left to us for mere refinement. The entity most responsible for the result of the order as it stands is the Court, which clearly mandated us to achieve a balance between utility and ratepayer which we have finally done. We have also protected eligibility by carefully remaining within the confines of the tax laws and regulations. No one, however, should be confused on the latter point. The *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be.
San Francisco, California
September 13, 1977

/s/ RICHARD D. GRAVELLE
RICHARD D. GRAVELLE, Commissioner

/s/ CLAIRE T. DEDRICK, Commissioner
CLAIRE T. DEDRICK, Commissioner

PACIFIC TELEPHONE & TELEGRAPH COMPANY

GENERAL TELEPHONE COMPANY OF CALIFORNIA

Re: Accelerated Depreciation and Investment Tax Credit

COMMISSIONER WILLIAM SYMONS, JR., Dissenting

California stands to lose at least a billion dollars, with nothing to gain, as the Public Utilities Commission majority again plays brinkmanship with the United States Government. There is no need to recklessly risk eligibility for such enormous sums in federal tax deferrals and federal tax forgiveness.

Congress enacted the federal tax laws, and in order to qualify for specific federal tax benefits, it is realistic to expect that the intentions of Congress be respected. Eligibility under the federal tax laws makes it possible for the communication companies in California to use accelerated depreciation and to receive investment tax credit. To have the federal government forego the collection of these taxes is most beneficial to both the utilities and the ratepayers. To risk these tax benefits so needlessly is bad regulatory administration. Loss of eligibility through 1976 as a consequence of California Public Utilities Commission action means that Pacific Telephone will have to pay taxing authorities in Washington, D.C., retroactive tax bills of $764 million. General Telephone will have to pay $223 million. Loss of eligibility into the future will cost our communication system and ratepayers additional hundreds of millions of dollars in taxes.

I cannot support a decision which fails to take the opportunity to resolve the "eligibility" issue before the Commisson decision is finalized and "set in concrete". Assurance on the issue of eligibility is proceduraly feasible if we were to follow the recommendation of the Administrative Law Judge in this case. The order as originally drafted deferred any effective date until 180 days. This was done to allow the utilities a reasonable period to obtain a ruling on eli-

gibility from the U.S. Internal Revenue Service. Ratepayer interest would have been protected by adequate accounting, refund, and interest provisions.

But today's majority strikes out that simple safeguard. In doing so they ignore the fact that last year's schemes, which the majority recklessly imposed on the state's largest electric utility and the state's largest gas utility, are in grave danger of causing millions of dollars in unnecessary tax liabilities to fall upon those companies. (See Majority and Minority Opinions: A. 54946 *Southern California Edison Company,* D. 86794, December 21, 1976; rehearing based on adverse tax attorney opinion, D. 87828, September 7, 1977; and A. 55676, *Southern California Gas Company,* D. 85627, March 30, 1976, together with adverse IRS ruling, dated November 22, 1976; California Supreme Court decision pending, in Case SF 23495.)

In light of these danger signals, it is imprudent of the Commission not to exhaust available consultive procedures and thus safeguard the state against the catastrophic consequences of ineligibility.

Instead, the majority lectures Congress on legislative goals. Acting as a school marm to Congress, the majority tells the national legislature that federal tax credits and deferrals may be used to lower monthly utility bills, but may not be used to stimulate job development or accelerated capital investment. Such homey advice is interesting but what the California ratepayer will have to worry about is the bottom line. What will he and the California utility companies have to pay to Washington, D.C., after the IRS has cut through the verbiage of this decision and applied the law?

San Francisco, California

September 13, 1977

/s/ WILLIAM SYMONS, JR.
WILLIAM SYMONS, JR.

COMMISSIONER VERNON L. STURGEON, Dissenting

The inconsistent and cavalier manner in which the majority treats the key issue of eligibility for accelerated depreciation warrants my strong dissent. The majority recognizes, as it must, that our regulatory treatment of accelerated depreciation and the investment tax credit (ITC) *must* preserve General's and Pacific's eligibility for these tax saving methods. The majority, in one of its few realistic comments on the question, states that:

> "Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision." (Mimeo p. 19)

After recognizing and elaborating upon the importance of eligibility, the majority then, incredibly, moves quickly to jeopardize that eligibility by adopting a regulatory accounting scheme whose compliance with the standards of normalization established by the Internal Revenue Code and Treasury Regulations *must* be considered a matter of speculation. While the majority states confidently (Finding No. 3) that "This method complies with Treasury Regulation 1.167(*l*)-(1)(h)(6) and is normalization accounting," they admit (at Mimeo p. 41) that "We have here a case of first impression under the tax laws . . ."

The Examiner's Proposed Report took a sensible approach to the eligibility question by setting an effective date 180 days after the entry of the order. Had a majority of the Commission had the wisdom to adopt such an approach, Pacific and General would have not only the time but the incentive to seek an expeditious IRS ruling. The majority correctly points that "expeditious" is not an adjective frequently associated with IRS rulings (as it is not with deci-

sions of this Commission). However, even if no such ruling were issued within the 180 days following the entry of the order, what harm would occur? Under the Examiner's approach, the order would simply be final at that time. If a ruling was issued, the Commission would then have the opportunity to modify the order if necessary.

It is doubtful that any of the majority would, in the handling of their own federal income taxes, make a decision involving a risk of substantial tax liability in which their position rested on a legal position which they knew to be a "case of first impression under the tax laws." Today, however, they have asked Pacific, General and their ratepayers to do just that.

/s/ VERNON L. STURGEON
VERNON L. STURGEON
Commissioner

San Francisco, California

September 13, 1977

APPENDIX C

APPENDIX C

Article VI of the Constitution:

> * * * This Constitution, and the laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the Supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding. * * *

The Fourteenth Amendment to the Constitution:

> * * * nor shall any State deprive any person of life, liberty or property, without due process of law * * * *

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 46. AMOUNT OF CREDIT.

* * * *

(f) [as amended by Sec. 105(c), Revenue Act of 1971, P.L. 92-178, 85 Stat. 503, Sec. 302(a), Tax Reduction Act of 1975, P.L. 94-12, 89 Stat. 40, and Sec. 1906(b)(13)(A), Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1834] LIMITATION IN CASE OF CERTAIN REGULATED COMPANIES.—

(1) GENERAL RULE.—Except as otherwise provided in this subsection, no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection); or

(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is

applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, the immediately preceding sentence shall not apply to property described in paragraph (5)(B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5)(B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

(2) Special rule for ratable flow-through.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) Cost of service reduction.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

(B) Rate base reduction.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

* * * *

(4) Limitation.—

(A) In general.—The requirements of paragraphs (1), (2), and (9) regarding cost of service and rate base adjustments shall not be applied to public utility property of the taxpayer to disallow the credit with respect to such property before the first final determination which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect with respect to public utility property (to which this subsection applies) of the taxpayer. Thereupon, paragraph (1), (2), or (9) shall apply to disallow the credit with respect to public utility property (to which this subsection applies) placed in service by the taxpayer—

(i) before the date that the first final determination, or a subsequent determination, which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect, and

(ii) on or after the date that a determination referred to in clause (i) is put into effect and before the date that a subsequent determination thereafter which is consistent with paragraph (1), (2), or (9) (as the case may be) is put into effect.

(B) Determinations.—For purposes of this paragraph, a determination is a determination made with respect to public utility property (to which this subsection applies) by a governmental unit, agency, instrumentality, or commission or similar body described in subsection (c)(3)(B) which determines the effect of the credit allowed by section 38 (determined without regard to this subsection)—

(i) on the taxpayer's cost of service or rate base for ratemaking purposes, or

(ii) in the case of a taxpayer which made an election under paragraph (2) or the election described in paragraph (9), on the taxpayer's cost of

service for ratemaking purposes or in its regulated books of account or rate base for ratemaking purposes.

(C) SPECIAL RULES.—For purposes of this paragraph—

(i) a determination is final if all rights to appeal or to request a review, a rehearing, or a redetermination, have been exhausted or have lapsed.

(ii) the first final determination is the first final determination made after the date of the enactment of this subsection, and

(iii) a subsequent determination is a determination subsequent to a final determination.

(5) PUBLIC UTILITY PROPERTY.—For purposes of this subsection, the term ''public utility property'' means—

(A) property which is public utility property within the meaning of subsection (c)(3)(B), and

(B) property used predominantly in the trade or business of the furnishing or sale of (i) steam through a local distribution system or (ii) the transportation of gas or steam by pipeline, if the rates of such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in subsection (c)(3)(B).

(6) RATABLE PORTION.—For purposes of determining ratable restorations to base under paragraph (1) and for purposes of determining ratable portions under paragraph (2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

(7) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

* * * *

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * *

(*l*) [as amended by Sec. 441(a), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 625, and Sec. 1906(b)(13)(A), Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1834] REASONABLE ALLOWANCE IN CASE OF PROPERTY OF CERTAIN UTILITIES.—

(1) PRE-1970 PUBLIC UTILITY PROPERTY.—

(A) IN GENERAL.—In the case of any pre-1970 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(i) a subsection (*l*) method, or

(ii) the applicable 1968 method for such property.

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

(B) Flow-through method of accounting in certain cases.—In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—

(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

(2) Post-1969 public utility property.—In the case of any post-1969 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(A) a subsection (*l*) method.

(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

(3) Definitions.—For purposes of this subsection—

(A) Public utility property.—The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

(i) electrical energy, water, or sewage disposal services.

(ii) gas or steam through a local distribution system.

(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U. S. C. 701), or

(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(B) Pre-1970 public utility property.—The term "pre-1970 public utility property" means property which was public utility property in the hands of any person at any time before January 1, 1970.

(C) Post-1969 public utility property.—The term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(D) Applicable 1968 method.—The term "applicable 1968 method" means, with respect to any public utility property—

(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of

same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

(iii) if neither clause (i) nor (ii) applies, a subsection (*l*) method.

In the case of any section 1250 property to which subsection (j) applies, the term "applicable 1968 method" means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.

(E) Applicable 1968 method in certain cases.—If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (*l*) method) with respect to any public property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be its applicable 1968 method with respect to such property and public utility property of the same (or similar) kind subsequently placed in service.

(F) Subsection (*l*) method.—The term "subsection (*l*) method" means any method determined by the Secretary to result in a reasonable allowance under subsection (a), other than (i) a declining balance method, (ii) the sum of the years-digits method, or (iii) any other method allowable solely by reason of the application of subsection (b)(4) or (j)(1)(C).

(G) Normalization method of accounting.—In order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

(H) Flow-through method of accounting.—The taxpayer used a "flow-through method of accounting" with respect to any public utility property if it used the same method of depreciation (other than a subsection (*l*) method) to compute its allowance for depreciation under this section and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

(I) July 1969 accounting period.—The term "July 1969 accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its tax expense for purposes of reflecting operating results in its regulated books of account.

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

* * * *

(5) Reorganizations, assets acquisitions, etc.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business

of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

(m) CLASS LIVES.—

(1) IN GENERAL.—In the case of a taxpayer who has made an election under this subsection for the taxable year, the term "reasonable allowance" as used in subsection (a) means (with respect to property which is placed in service during the taxable year and which is included in any class for which a class life has been prescribed) only an allowance based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group. The allowance so prescribed may (under regulations prescribed by the Secretary) permit a variance from any class life by not more than 20 percent (rounded to the nearest half year) of such life.

(2) CERTAIN FIRST-YEAR CONVENTIONS NOT PERMITTED.—No convention with respect to the time at which assets are deemed placed in service shall be permitted under this section which generally would provide greater depreciation allowances during the taxable year in which the assets are placed in service than would be permitted if all assets were placed in service ratably throughout the year and if depreciation allowances were computed without regard to any convention.

(3) MAKING OF ELECTION.—An election under this subsection for any taxable year shall be made at such time, in such manner, and subject to such conditions as may be prescribed by the Secretary by regulations.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.167(*l*)-1. Limitations on reasonable allowance in case of property of certain public utilities.

(a) *In general*—(1) *Scope*. Section 167(*l*) in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to "public utility property" (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for "pre-1970 public utility property" and in paragraph (d) of this section for "post-1969 public utility property." Under section 167(*l*), a taxpayer may always use a straight line method (or other "subsection (*l*) method" as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection (*l*) method is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a "normalization method of regulated accounting" (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection (*l*) method is not prohibited by section 167(*l*) if the taxpayer used a "flow-through method of regulated accounting" described in paragraph (i) of this section) for its "July 1969 regulated accounting period" (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a method of depreciation other than a subsection (*l*) method be used in the case of pre-1970 public utility property unless such method of depreciation is the "applicable 1968 method" (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(*l*) with respect to public utility property defined in section 167(*l*)(3)(A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance

for depreciation under section 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167(*l*) do not pertain to other book-tax timing differences with respect to State income taxes, F. I. C. A. taxes, construction costs, or any other taxes and items. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. The formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer. The formula serves to limit the amount of such disallowance.

* * * *

(h) *Normalization method of accounting*—(1) *In general.* (i) Under section 167(*l*), a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(*a*) If the same method of depreciation (whether or not a subsection (*l*) method) is used to compute both its

tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(*b*) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (*a*) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167(*l*)(1)(B) or (2)(C), the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's "qualified public utility property". See § 1.167(*l*)-2(b) for definition of "qualified public utility property".

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (*l*) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (*l*) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (*l*) method,

then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

* * * *

(6) *Exclusion of normalization reserve from rate base.* (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(*l*) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

(ii) For the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of this subparagraph, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any pro-

jected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974, for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974, whether or not such order is final, appealable, or subject to further review or reconsideration.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(*l*)(2)(B) to use a method of depreciation other than a subsection (*l*) method if it uses a normalization method of regulated accounting. With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12-month period ending not more than 4 months prior to the date of filing a rate case adjusted for certain known changes occurring within

a 9-month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is $145,000,000. The amount of the reserve for deferred taxes under section 167(*l*) at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example (2). Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167(*l*) at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be

January	1-31	$ 310,000
February	1-28	300,000
March	1-31	300,000
April	1-30	280,000
May	1-31	270,000
June	1-30	260,000

July	1-31	260,000
August	1-31	250,000
September	1-30	240,000
		$2,470,000

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$$
\begin{aligned}
\$310{,}000 \times 243/273 &= \$\ 275{,}934 \\
300{,}000 \times 215/273 &= 236{,}264 \\
300{,}000 \times 184/273 &= 202{,}198 \\
280{,}000 \times 154/273 &= 157{,}949 \\
270{,}000 \times 123/273 &= 121{,}648 \\
260{,}000 \times 93/273 &= 88{,}571 \\
260{,}000 \times 62/273 &= 59{,}048 \\
250{,}000 \times 31/273 &= 28{,}388 \\
240{,}000 \times 1/273 &= 879 \\
\hline
&\ \ \$1{,}170{,}879.
\end{aligned}
$$

Example (3). Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977. Assume further that plant additions, depreciation expense, and taxes are projected to the end of 1975 and

that the reserve for deferred taxes under section 167(l) is $1,300,000 for 1974 and is projected to be $4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of $145,-000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base ($145,000,000) greater than $1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be

1st quarter	$ 910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000
	$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a matter of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is $2,591,480 (the amount of the reserve at the beginning of the period ($1,300,000) plus a pro rata portion ($1,291,480) of the $3,100,000 projected increase to be credited to the reserve during the period). Such portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$910,000	×	276/365	=	$ 688,110
810,000	×	185/365	=	410,548
750,000	×	93/365	=	191,096
630,000	×	1/365	=	1,726
				$1,291,480

APPENDIX D

APPENDIX D

INTERNAL REVENUE SERVICE DEPARTMENT OF THE TREASURY

Index Number 0167.23-00

Washington, DC 20224

Mr. Robert Dalenberg
Vice-President & General Counsel
Pacific Telephone & Telegraph
Company
140 New Montgomery Street
San Francisco, California 94105

Date: 8 June 1978

Taxpayer—Pacific Telephone & Telegraph Co.*

State—California

Commission—California Public Utility Commission

Parent—American Telephone & Telegraph Co.

Representative—Caplin & Drysdale

Decision X—87838, September 13, 1977

Dear Mr. Dalenberg:

This replies to your ruling request dated September 29, 1977, as supplemented, the latest being dated May 3, 1978, and filed on your behalf by your representatives concerning your company (taxpayer).

You request a ruling that should Decision No. X of the Commission, dated September 13, 1977, become final, will the taxpayer remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; 2) depreciation based on Class Lives Asset Depreciation

* The comparable ruling issued to General is printed in this Appendix, *infra*, pp. 116A-131A.

Range (CLADR) system for post-1970 public utility property; 3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and 4) the investment tax credit?

Taxpayer is a state corporation and is a subsidiary of its parent, which has its principal place of business at 195 Broadway, New York, New York 10007. Taxpayer is subject to regulation by the Commission with respect to its intrastate rates and services. It is a member of a group of affiliated corporations which files consolidated Federal income tax returns under section 1501 of the Code.

By letter dated December 22, 1977, you have formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. Based on your request, we are replying to the first three issues in this ruling letter and will reply to the investment tax credit issues at a later date.

Several state utilities, taxpayer not being one of them, elected accelerated depreciation in the 1950's and chose to establish a reserve on their books of account and for ratemaking purposes for the deferred taxes. This was a normalization method of accounting.

In 1960 the Commission determined that the flow-through method of accounting was to be used in setting rates for utilities using accelerated depreciation for tax purposes. Taxpayer did not elect the accelerated method of depreciation, but chose to remain on the straight line method for tax purposes (until 1970) and in computing depreciation expense in its regulated books of account. Thus, taxpayer used a straight line method of depreciation for both its regulated books of account and for tax purposes for its pre-1970 public utility property.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 public utility property. Pursuant to section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations, the taxpayer has normalized, based on

straight line depreciation, the difference between the longer book lives (to compute depreciation for book purposes) and the shorter CL system lives (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

Pursuant to the Tax Reform Act of 1969, the taxpayer made a timely election to use accelerated depreciation to compute depreciation expense for determining its Federal income tax, beginning with its 1970 tax return and used the normalization method of accounting. Therefore, taxpayer in using an accelerated method of depreciation with respect to its post-1969 public utility property. As taxpayer was using the straight line method of depreciation, as provided under section 167(l)(1)(A) of the Code, for tax purposes on August 1, 1969, it was not eligible to use the flow-through method of accounting.

Taxpayer has made a timely election to use the CLADR system for its post-1970 public utility property. Pursuant to section 1.167(a)-11(b)(6)(ii) of the regulations, the taxpayer has normalized the difference between the book lives (to compute depreciation for book purposes) and the power limit of the appropriate asset guideline range (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

The Commission issued a decision on November 6, 1968, concerning taxpayer, establishing rates by reducing taxpayer's tax expense for the test year 1967 as though it had used accelerated depreciation on its 1967 tax return. By computing accelerated depreciation with flow-through, the Commission gave the ratepayers the benefit of a tax deferral which the taxpayer did not actually realize. With the taxpayer's announced use of accelerated depreciation the

Commission issued an interim decision on November 24, 1970, holding that taxpayer's rates would be established to reflect its use of accelerated depreciation and the normalization method of accounting. On June 22, 1971, the Commission granted a rate increase to taxpayer based on the interim decision.

On November 26, 1971, the state Supreme Court annulled the interim decision of November 24, 1970, holding that the Commission had erred in failing to consider lawful alternatives to normalization. The court ruled that imputed accelerated depreciation with flow-through was a lawful alternative, but remanded to the Commission for consideration of all alternatives, including normalization and any compromise between normalization and imputed accelerated depreciation with flow-through. The court then annulled the Commission's June 22, 1971 decision and ordered the Commission to reinstate the rates established in the 1968 decision. On July 23, 1974, the Commission issued a decision granting taxpayer a rate increase based on accelerated depreciation with normalization. The Commission adopted normalization to preserve the taxpayer's eligibility for accelerated depreciation.

On December 12, 1975, the court annulled that part of the Commission's 1974 order relating to the treatment of tax expense, resulting from the use of accelerated depreciation, principally because the court disagred with the Commission's conclusion that it had no regulatory authority to consider alternate methods of treating the accelerated depreciation. The court remanded for further proceeding relating to tax expense.

Following additional hearings, the Commission issued Decision X on September 13, 1977. This decision covers the tax issues in three separate rate cases using test periods for: 1) calendar year 1973; 2) fiscal year 7/1/74-6/30/75 and; 3) fiscal year 7/1/75-6/30/76. The Commission ordered the taxpayer to make refunds and annual reductions in rates with respect to these cases.

It seems the Commission had the view that full flow-through of the tax deferral resulting from using accelerated depreciation was the proper and best ratemaking method, but could not consider it as the taxpayer was not eligible for this method of accounting, since taxpayer was using straight line depreciation on August 1, 1969.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed an "average annual adjustment method." In its presentation of this method, the Commission has attempted to take into account section 1.167(*l*)-1(h)(6) of the regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes.

Decision No. X states that the theory of the method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjusted for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses the taxpayer's actual reserve for deferred taxes for the years 1973, 1974 and 1975, and estimated plant additions for the succeeding three years of each test year and computed the estimated reserve for deferred taxes for these years. The simple average of the average annual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property for the four year period was deducted from the rate base, that was adjusted for the test year depreciation reserve, but not for the additional estimated depreciation reserve for the succeeding three years.

As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this amount from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income was then substituted in the cost of service for the larger test year net operating income figure and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the larger test year tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The Commission believes the taxes set aside in the deferred tax reserve shall never be paid and amounts to a tax savings rather than a tax deferral. The depreciation expense, included in the cost of service, was left undisturbed.

The Commission believes the normalization method of accounting does not approach the only sensible and realistic method of setting rates, that is, using the actual tax expense as the cost of service tax expense. It believes their annual average adjustment adopted in its Decision No. X "is a more equitable and realistic method of normalization than the other proposals and the best available now."

Decision No. X states that the actual Federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it and cites an exhibit submitted by the taxpayer in a rate case. It believes that the Code or regulations thereunder do not discuss the estimating process and believes that this method uses the same time period for estimating the reserve for deferred taxes and the tax expense for establishing cost of service for ratemaking purposes; and that section 1.167(*l*)-1(h)(6) of the regulations is satisfied and eligibility is maintained for

accelerated depreciation, CLADR system and the CL system.

In reviewing the taxpayer's record in the proceedings, it came to the attention of the Commission that for the 1968 and 1969 vintage plant additions no accelerated depreciation was ever reflected in taxpayer's rates. In a previous application of taxpayer, imputed flow-through was proposed for the 1968 and 1969 vintage accounts. Decision No. X adopted this imputed flow-through for these years and used it to determine tax expense in each of the three taxpayer's test year cost of services for ratemaking purposes to compute the reduction in rates and the amount of the refund.

The taxpayer became concerned when the Commission's Decision No. X was issued and therefore requested the present ruling to determine whether the decision would impair its eligibility for accelerated depreciation, use of CLADR system under section 1.167(a)-11 of the regulations and the CL system under section 1.167(a)-12. If the decision becomes final and is inconsistent with the Code and regulations thereunder, taxpayer stated it will have enormous Federal tax obligations for both past and future years. The request for this ruling is the result of the Commission's decision.

The taxpayer states it is following the normalization method of accounting in regard to accelerated depreciation under section 167(*l*) of the Code and adhering to the normalization of tax deferrals resulting from the use of shorter lives for tax purposes than are used for regulatory purposes to comply with section 1.167(a)-11(b)(6)(ii) of the regulations for post-1970 public utility property CLADR system and section 1.167(a)-12(a)(4)(iii) for pre-1971 public utility property CL system.

It is the taxpayer's belief that the average annual adjustment method is the same as the method proposed by the Commission's staff several years ago and rejected by the

Commission as being inconsistent with section 167(l) of the Code and regulations thereunder. The taxpayer states that the simple average of the reserve for deferred taxes that is excluded from the rate base is greater than the amount of the reserve for deferred taxes excluded from the test year rate base. Therefore, the exclusion of a larger deferred tax reserve covering a different time period than the time period used in determining tax expense for cost of service purposes is precisely what section 1.167(l)-1(h)(6) of the regulations prohibits.

The taxpayer further states that when a computation is made of net revenue reduction, it has a bearing on tax expense because of the necessary mathematical relationship between after-tax net revenues and Federal income taxes. The taxpayer believes the Commission's computation is not how the tax expense under section 1.167(l)-1(h)(6)(i) of the regulations should be computed, otherwise this section of the regulations would have no meaning as far as the amount of the reserve for deferred taxes to be deducted from the rate base is concerned. The taxpayer believes the tax expense as computed under the average annual adjustment method does not represent actual or a proper estimated tax expense for the test year, any future year, or any average of these years.

The taxpayer is also concerned about the Commission's use of the actual reserve for deferred taxes being used for the calendar years 1973, 1974 and 1975, while using estimated figures for all other cost of service items, including tax expense. The deferred tax reserve figures for each of the test years were substantially higher than the original estimated figures, as more property was placed in service than originally estimated.

Should the Commission amend its decision to eliminate the four-year forward averaging of the reserve for deferred taxes, the taxpayer states the deferred portion of normalized tax expense included in the cost of service for each test

year would still be equal to the lower estimated figure, while the deferred portion of the normalized tax expense excluded from the rate base would be equal to the higher actual figure. Therefore, the taxpayer believes the amount credited to the reserve and excluded from the rate base should be based on the deferred portion of the tax expense as stated under sections 1.167(l)-1(h)(1)(i) and (iii) of the regulations. The taxpayer further states that if the larger actual amount of the reserve is excluded from the rate base then the actual tax expense must be included in the cost of service for ratemaking purposes, otherwise the exclusion of the larger actual amount of the reserve for deferred taxes, without the use of the actual tax expense, would be in violation of section 1.167(l)-1(h)(6).

In regard to the question of being eligible for the continued use of accelerated method of depreciation for its post-1969 public utility property when the Commission has ordered imputed flow-through treatment with respect to the taxpayer's 1968 and 1969 vintage accounts, taxpayer states that it computes depreciation allowance for its 1968 and 1969 vintage accounts for both its regulated books of account and tax purposes on the straight line method in accordance with section 167(l)(1)(A) of the Code. Also, the imputed flow-through method of accounting for the 1968 and 1969 vintage accounts does not prevent the use of the accelerated methods of depreciation for its post-1969 public utility property. The taxpayer cites section 1.167(l)-1(d)(2)(ii) of the regulations, and believes that the phrase, "with respect to the property" means the normalization requirements with respect to the property on which accelerated depreciation is claimed. The taxpayer believes the normalization method of accounting need not be followed for all property as a condition to using accelerated depreciation for post-1969 public utility property.

In regard to the question of being eligible to continue the use of the CL system for pre-1971 property, the taxpayer states the Commission's treatment of the 1968 and 1969

vintage accounts relates only to accelerated depreciation and does not reflect any adjustment of the shorter lives for the property under the CL system than are being used in computing tax expense and depreciation expense in the cost of service for ratemaking purposes. The taxpayer therefore believes the Commission's imputed flow-through of accelerated depreciation for the 1968 and 1969 vintage accounts does not impair its eligibility to use the CL system with respect to these vintage accounts.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167(*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-11(a)(1) of the regulations provides an optional election of an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970.

Section 1.167(a)-11(b)(6)(ii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating result in its regulated books of account. The normalization method of accounting shall have the same definition as stated in sections 167(*l*)(3)(G) of the Code and 1.167(*l*)-1(h).

Section 1.167(a)-11(b)(6)(iii) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(a)-12(a) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. This applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting

shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (*l*) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(*l*)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(*l*)-1(d)(2)(ii) of the regulations provides that under section 167(*l*)(2) of the Code, in the case of post-1969 public utility property, the term "reasonable allowance" means a subsection (*l*) method or a method of depreciation otherwise allowable under section 167 if with respect to the property the taxpayer uses a normalization method of regulated accounting.

Section 1.167(*l*)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(*l*)(3)(G) of the Code.

Section 1.167(*l*)-1(h)(2) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(*l*)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (*l*) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public property.

Section 1.167(*l*)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(*l*)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of

any projected increase to be credited or decreased to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of that period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flowing-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(l) of the Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1,

1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so, unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The question presented whether the taxpayer will remain eligible for: (1) accelerated depreciation under section 167(l) of the Code; (2) depreciation based on the CLADR system for post-1970 public utility property; and (3) depreciation based on CL system for pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(l)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking pur-

poses was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167(*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years 1973, 1974 and 1975 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

The election of the CLADR system under section 1.167(a)-11(b)(6)(ii) of the regulations, pertaining to post-1970 public utility property, and the continued elective use of this system are conditioned upon the taxpayer following the normalization method of accounting as provided under section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1

(h)(1)(i). We believe the reserve for deferred taxes that is determined over the test year and the succeeding three year period, and includes the tax deferral as determined under section 1.167(a)-11(b)(6)(iii) that is deducted from the rate base, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

The election of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system, is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period, that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-11(b)(6)(iii) of the regulations pertaining to the elective use of the CLADR system, and under section 1.167(a)-12(a)(4)(iii) pertaining to the elective use the CL system, will result in the termination of the election of the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

There is a question in regard to the treatment of the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions to determine tax expense for the three test years to establish the cost of service for ratemaking purposes and whether such treatment conflicts with taxpayer's eligibility to use accelerated depreciation and the normalization method of accounting with respect to its post-1969 public utility property. The Tax Reform Act of 1969 recognized such a problem existed. To remedy this trend to accelerated depreciation and flow-through whether

imputed, or otherwise, Congress froze the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(*l*) of the Code. Implementing regulations were published. Regardless of what went on before this date if the public utility used straight line depreciation for its pre-1970 public utility property, it would make a timely election to apply accelerated depreciation to its post-1969 public utility property, provided it uses the normalization method of accounting. The taxpayer in this case made a timely election to apply accelerated depreciation to his post-1969 public utility property in accordance with section 167(*l*)(2)(B) of the Code and section 1.167(*l*)-1(d)(2)(ii) of the regulations. The continued use of accelerated depreciation is dependent upon the taxpayer following the normalization method of accounting as to its post-1969 public utility property and is not affected by the Commission's use of imputed flow-through as to pre-1970 vintage plant additions.

There also is a question in regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1968 and 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions. The use of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The Commission's use of imputed flow-through for the 1968 and 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

A schedule submitted by the taxpayer, dated March 7, 1978, showed that its depreciation expense, Federal income tax expense (normalized), average rate base and average reserve for deferred taxes increased, along with the addition of plant facilities over a period of 5 years (1973-1977 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the

form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153, it states that taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(1)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation. Additionally, the Commission's imputed flow-through of the 1968 and 1969 vintage plant

additions will not be cause for the taxpayer being ineligible to use an accelerated method of depreciation along with the proper normalization method of accounting as to its post-1969 public utility property. The taxpayer made a timely election to use an accelerated method of depreciation and the election is applicable only to its post-1969 public utility property.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe that it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount as permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on CLADR system property and the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(l)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of both the CLADR system and the CL system at the begin-

ning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1968 and 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii) of the regulations.

Very truly yours,

/s/ GEOFFREY J. TAYLOR
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

INTERNAL REVENUE SERVICE — Department of the Treasury
Index Number 0167.23-00 — Washington, DC 20224

Mr. A. M. Hart
General Telephone Company
of California
100 Wilshire Boulevard
Santa Monica, California 90401

Date: 9 June 1978

Taxpayer—General Telephone Company of California

State—California

Commission—California Public Utility Commission

Parent—General Telephone & Electronics Corporation

Representatives—Covington & Burling

Decision X—87838—September 13, 1977

Dear Mr. Hart:

This replies to a ruling request, dated September 29, 1977, as supplemented, the latest being dated April 21, 1978, filed on your behalf by your representatives.

You request a ruling whether your company (taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; (2) the Class Life (CL) system with respect to the pre-1971 public utility property (1969 vintage accounts) under section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations; and (3) the investment tax credit if Decision No. X of the Commission, dated September 13, 1977 becomes final?

Taxpayer is a wholly owned subsidiary. The principal offices of its Parent are at One Stamford Forum, Stamford, Connecticut 06940. Taxpayer is principally engaged in the business of providing telephone service to residential, commercial, and industrial customers within the state of its incorporation, and its intrastate rates are regulated by the Commission of that state.

By letter dated January 24, 1978 you stated that you are concerned with a timely response to the issues concerning accelerated depreciation under section 167(*l*) of the Internal Revenue Code of 1954 and the CL system with respect to pre-1971 property. You ask that the ruling request be treated as two separate ones, with the response to the two depreciation issues first, and the response to the investment credit issue at a later date. In compliance with that request, we are ruling on the first two issues in this ruling letter and will reply to the investment tax credit issue at a later date.

In 1960 the Commission determined that the flow-through method of accounting was mandatory for utilities electing accelerated depreciation for tax purposes. The election of accelerated depreciation was left to the utility companies and taxpayer remained on straight line depreciation for tax purposes through 1969.

For its pre-1970 public utility property taxpayer used straight line depreciation for computing both its tax expense and depreciation expense for establishing its cost of service for ratemaking purposes, in its regulated books of account, and for actual tax purposes.

After August 1, 1969, the taxpayer, in accordance with the Tax Reform Act of 1969, made a timely election to use accelerated depreciation for its post-1969 public utility property. It was permitted to do so by the Commission and to normalize the deferred taxes beginning with the year 1970.

The proceedings that resulted in Decision No. X, followed the remand by the State Supreme Court in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680, which annulled that portion of the rate increase granted another public utility and taxpayer, relating to accelerated depreciation and investment tax credit. In the remand of the case the court held that the Commission has the power to implement an alternative method, one that involves an annual adjustment of the tax expense treatment for acceler-

ated depreciation and investment tax credit. The timely election by the taxpayer of accelerated depreciation, commencing with its taxable year 1970, led to the proceedings in which the Commission in its Decision No. X has attempted to comply with the mandate from the court to reach an equitable determination of the election of accelerated depreciation. In its presentation of the "average annual adjustment method," the Commission has attempted to take into account section 1.167(l)-1(h)(6) of the Income Tax Regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes. The taxpayer has before the Commission three rate cases using calendar year test periods 1970, 1974 and 1976.

It seems that the Commission viewed the full flow-through as being the proper and best ratemaking method, but since the taxpayer was not using an accelerated method of depreciation on August 1, 1969, flow-through could not be required.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed the "average annual adjustment method."

Decision No. X states that the theory of this method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses actual deferred tax amounts through 1976 and estimated amounts thereafter. This method consists of taking the simple aver-

age of the average annual reserve for deferred tax for both pre-1970 public utility property and post-1969 public utility property for the four year period and deducting this amount from the rate base, adjusted for the test year depreciation reserve, but not for the additional depreciation reserve for the succeeding three years. As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this deferred tax reserve from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income figure was then substituted in the cost of service for the larger net operating income figure of the test year and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the test year's larger tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The depreciation expense, included in the cost of service, was left undisturbed.

Decision No. X states that pertinent sections of the Internal Revenue Code and regulations thereunder do not discuss the estimating process. Apparently, the Commission is of the view the method set forth in its decision uses the same time period for estimating both the reserve for deferred taxes and the tax expense for cost of service for ratemaking purposes; that section 1.167(l)-1(h)(6) of the regulations is satisfied; and eligibility for accelerated depreciation is maintained because while the method is different, the principle is identical to the ordinary test year principle. The Commission seems to take the view that the taxes set aside in the reserve for deferred tax account will never be paid and thus will amount to an actual tax savings rather than a tax deferral.

In reviewing the record of the taxpayer's proceedings it came to the attention of the Commission that 1969 vintage plant additions were not previously considered in the ratemaking process. Decision No. X therefore included the 1969 vintage accounts in the ratemaking process by imputing flow-through of accelerated depreciation for that property.

In a previous Commission decision, it imputed flow-through of accelerated depreciation for taxpayer for its 1968 vintage plant using a 1968 test year. In a later decision, the Commission ordered increased rates using the normalization method of accounting for the accelerated depreciation beginning with 1970 vintage plant additions. The 1969 vintage plant additions never were reflected in taxpayer's rates. Imputed accelerated depreciation and flow-through was proposed by the Commission for the 1969 vintage plant additions and adopted in Decision No. X and continued through tests years 1970, 1974 and 1976.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 property for taxable years beginning with the year 1971, and has consistently used the straight line method of depreciation for both book and tax purposes for the 1969 vintage accounts and prior year accounts.

The taxpayer cites sections 1.167(*l*)-1(a)(1) and (2) and 1.167(*l*)-1(h)(6) of the regulations, and states that these regulations mandate synchronization of the reserve for deferred taxes that is deducted from the rate base with the corresponding tax expense that is included in the cost of service. It also states that, in accordance with section 1.167(*l*)-1(a)(1) the reserve for deferred taxes is to be increased only by the excess accelerated depreciation over the depreciation used in computing both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes.

The Commission had stated that based on an exhibit submitted by the taxpayer in a rate case, the actual Federal

tax expense bears no direct relation to the increase in deferred tax reserve but fluctuates independently of it. The taxpayer states that the figures in this exhibit need to be adjusted for straight line depreciation and investment tax credit to portray normalized tax expense. A table was submitted by taxpayer showing that actual increased plant additions resulted in additional revenues, Federal income tax expense, and net operating income over a period of seven years.

The taxpayer believes that since the increased depreciation accruing from the estimated plant additions has not been used to compute the depreciation expense included in the cost of service for ratemaking purposes, the estimated reserve for deferred taxes does not exist and there can be no additional exclusion from the rate base. The taxpayer also states the Commission's average annual adjustment method would require more than a permissible deduction of the reserve for deferred taxes from the rate base and the taxpayer would not be permitted to use an accelerated method of depreciation.

In regard to the election of the CL system, taxpayer states that, in conformity with section 1.167(a)-12(a)(4)(iii) of the regulations, and using straight line depreciation, it has normalized the difference in depreciation between that which is based on the longer lives used for book purposes and that which is based on the shorter CL system lives used to compute depreciation for actual tax purposes.

The taxpayer states it has never used accelerated depreciation for its 1969 vintage plant additions. Thus, the deferred tax reserve required to be flowed-through by the Commission's imputed accelerated method of depreciation does not actually exist on taxpayer's books. Taxpayer states that the flow-through is a purely hypothetical deferred tax reserve tha' would have developed by reason of the difference between the fictional tax based on accelerated depreciation and the actual amount of tax paid based on straight line depreciation.

The taxpayer has normalized and will continue to normalize all tax deferrals resulting from the election of the CL system.

The taxpayer believes that if a taxpayer who is required to normalize with respect to qualified public utility property fails to normalize, the election to apply class lives shall terminate as of the beginning of the tax year for which the taxpayer fails to normalize. Taxpayer believes that since Decision No. X imputed flow-through with respect to its 1969 vintage plant additions beginning in 1970, it will not be entitled to use class lives for such property for any year.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167 (*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to

compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-12(a)(1) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970 and applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property for which no guideline life was prescribed in Rev. Proc. 62-21 shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is, the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.67(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (1) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting

operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(l)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(l)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(l)(3)(G) of the Code.

Section 1.167(l)-1(h)(2)(i) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(l)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (l) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property.

Section 1.167(l)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(l)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of the period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flow-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed-through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969 regarding methods of depreciation by enacting 167(l) of the

Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1, 1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing-through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permitted it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The questions presented, whether the taxpayer will remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Code and 2) depreciation based on the CL system with respect to the pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(*l*)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking purposes was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167 (*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years through 1976 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is

absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

In regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions, the use of this system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The imputed flow-through of accelerated depreciation for the 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

The election of the CL system under section 1.167(a)-12 (a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to the elective use the CL system will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

A schedule submitted by taxpayer, dated September 29, 1977, showed that its revenues, Federal income tax expense and net operating income increased, along with the addition of plant facilities, over a period of 7 years (1970-1976 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the Staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153 it states that the taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense, thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision No. X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(*l*)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL

system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii).

Very truly yours,

/s/ Geoffrey J. Taylor
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

APPENDIX E

APPENDIX E

INTERNAL REVENUE SERVICE	DEPARTMENT OF THE TREASURY
Index Number: 0046.01-00	Washington, D.C. 20224
	Date: July 27, 1978

Mr. Robert Dalenberg
Vice-President & General Counsel
Pacific Telephone & Telegraph Company
140 New Montgomery Street
San Francisco, California 94105

Taxpayer—Pacific Telephone & Telegraph Co.

State—California

Commission—California Public Utility Commission

Parent—American Telephone & Telegraph Co.

Representative—Caplin & Drysdale

Decision No. X.—87838, September 13, 1977

[*Mr. A. M. Hart*
General Telephone Company
of California
100 Wilshire Boulevard
Santa Monica, California 90401

Date: Aug. 9, 1978

Taxpayer	*General Telephone Company of California*
Commission	*California Public Utility Commission*
State	*California*
Parent	*General Telephone & Electronics Corp.*
Representatives	*Covington & Burling*
Decision X	*87838 - September 13, 1977*]*

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* Where the language of the ruling applicable to General differs from that of the ruling applicable to Pacific, the differing language in General's ruling is printed in italics in this Appendix.

Dear Mr. Dalenberg [*Mr. Hart*]:

This letter supplements ours of June 8, 1978, [*June 9, 1978*] in which we responded to your ruling request dated September 29, 1977, as supplemented, and filed on your behalf by the representative of your company.

You requested a ruling whether your company (the taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(l) of the Internal Revenue Code of 1954; (2) depreciation based on Class Lives Asset Depreciation Range (CLADR) system for post-1970 public utility property; (3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and (4) the investment tax credit should Decision No. X of the Commission become final.

[*You requested a ruling whether your company (taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(l) of the Internal Revenue Code; (2) the Class Life (CL) system with respect to the pre-1971 public utility property (1969 vintage accounts) under section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations; and (3) the investment tax credit should Decision No. X of the Commission, dated September 13, 1977, become final.*]

By letter dated December 22, 1977, [*January 24, 1978*] you formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. The reason for this was that there were final regulations covering section 167(l) of the Code but there were no final regulations for section 46(f). Based on your request, we replied to the first three issues in our ruling letter of June 8, 1978, [*June 9, 1978*] and are now replying to the investment tax credit issue in this letter.

There are no final regulations covering your investment credit issue under section 46(f) of the Internal Revenue Code of 1954. However, Rev. Proc. 72-3, 1972-1 C.B. 698,

sets out the conditions under which consideration will be given to the issuance of rulings in advance of the adoption of final regulations. This procedure provides in part that if an inquiry presents an issue on which the answer seems to be clear from the application of the provisions of the statute to the facts described, a ruling will be issued in accordance with specific procedures. This is considered to be such a ruling.

Finding 3 of the Commission's Decision No. X provides for a method of normalizing the tax deferral resulting from the difference between computing Federal income taxes using straight line depreciation expense used for ratemaking purposes and accelerated depreciation expense used **for actual Federal income taxes. Our letter of June 8, 1978 [*June 9, 1978*], dealt with this finding.**

Finding 4 of the Commission's Decision No. X provides that the Commission shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of investment tax credit estimated for the next immediate future calendar year as compared to the last year (or last preceding year), and recomputing Federal income tax expense and gross revenue requirements based on that new estimate for each year between rate cases. The Commission contends that this method complies with the requirements of ratable (service life) flow-through selected by the utility under section 46(f)(2) of the Code.

Finding 5 of the Commission's Decision No. X provides that the methods described in Findings 3 and 4 are an attempt to more accurately reflect in rates the abnormal growth in depreciation and investment credit tax reserves compared to the other components of cost of service used in computing rates.

Finding 6 of the Commission's Decision No. X provides that the methods adopted in Decision No. X, as described in Findings 3 and 4, comply with the mandate of the California Supreme Court as set forth in *City of Los Angeles v. Public Utilities Commission* (1975) 15 C 3d 680.

Pacific [*General*] has made a timely election to be governed by section 46(f)(2) of the Code in its accounting treatment of the investment tax credit for ratemaking purposes. Therefore, it is of vital concern to Pacific [*General*] to know whether the specific ratemaking treatment ordered by Decision No. X is consistent with the requirements of section 46(f)(2) of the Code in order that the investment tax credit not be disallowed should Decision No. X become final.

You have explained that [*As we understand*] the ratemaking treatment of investment credit contained in the Commission's Decision No. X involve the following steps [*the following steps are involved*] for each of the test years and subsequent years until the next rate case involving a new test year.

First, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test year. The depreciation expense in cost of service included depreciation on the investment in the property that had generated the credit (without any reduction in the basis of the property by any portion of the credit) and the rate base also included such property investment (unreduced by the credit).

Second, at the beginning of the year following the test year, the credit produced by additional investment in property for that coming year was determined. (In the case of future years, these amounts were estimated.) Cost of service as determined for the test year was then further reduced by a ratable amount of such credit; the net revenue requirement for the year following the test year was reduced dollar-for-dollar by that further reduction in cost of service; and rates were reduced for such following year on the basis of the reduction in gross revenue requirement determined by multiplying the net revenue requirement reduction by a net to gross multiplier.

Third, the process described in the second step was repeated for each succeeding year until the next rate case, which involved a new test year.

As explained further, [*Further, we understand that*] the significant features of these three steps from the standpoint of section 46(f)(2) of the Code are the differences between the treatment of the credit for the test year in the first step and the treatment of the credit in the second and third steps for years following the test year. In the first step, the only credit that was used to reduce cost of service was a ratable portion of the credit resulting from property investment that had been included (unreduced by the credit) both in rate base and in the basis from which the depreciation expense in cost of service was determined. Therefore, rate base was not reduced within the meaning of section 46(f)(2)(B) by any portion of the allowable credit that was used to reduce cost of service under section 46(f)(2)(A). Also, cost of service was reduced under section 46(f)(2)(A) only by a ratable portion of the credit. Cost of service was not reduced further by reduced depreciation expense since the depreciation basis included the total investment in the property (unreduced by the credit) that generated such credit.

By contrast, in the second and third steps, you have explained [*we understand*] that rates were recomputed for each coming year by the lone adjustment resulting from including a ratable portion of the coming year's credit in the reduction of cost of service. Although your net investment and depreciation expense thereon were increasing in each year affected by Decision No. X, no adjustment to rates was

made to reflect the net increase in rate base, or the net increase to the basis used to determine depreciation expense, due to the investment in the qualified property that gave rise to the credit. This net increase in investment was totally excluded in determining rate base and depreciation expense in each year following the test year. Therefore, you contend that there was, in effect, a further reduction in rates through a reduction to rate base by reason of the credit and a reduction to depreciation expense (as well as a reduction of tax expense by reason of the credit) in each such year.

Pacific [*General*] is concerned that the treatment of the credit for the years following the test years in the second and third steps does not conform to the requirements of either subparagraph (A) or subparagraph (B) of section 46(f)(2) of the Code. This concern arises because subparagraph (A) can be interpreted to mean that cost of service has been reduced by more than a ratable portion of the credit if, in addition to the reduction to cost of service by a ratable portion of the credit, depreciation expense has also been reduced because the property investment which produced the credit has not been used to reflect a net increase in the basis used to determine depreciation expense. Additionally, Pacific [*General*] is concerned because subparagraph (B) can be interpreted to mean that there has been a reduction to rate base by reason of the credit if the qualified property, which generated the credit used to determine the ratable reduction in cost of service under subparagraph (A), is not included in rate base to the extent such property represents a net increase in rate base.

Section 46(f)(2) of the Code provides that if the taxpayer makes an election under this paragraph within 90 days after the date of the enactments of this paragraph in the manner prescribed by the Secretary, section 46(f)(1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property of the taxpayer—

(A) —If the taxpayer's cost of service, for ratemaking purposes or in its regulated book of account, is reduced by more than a ratable portion of the credit allowable by section 38, or

(B) —If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38.

Section 46(f)(6) of the Code provides that for purposes of determining ratable restorations to rate base under section 46(f)(1) and for purposes of determining ratable portions under section 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Section 12.3(a) of the Temporary Income Tax Regulations provides that a public utility may make one of two elections under section 46(f) of the Code (section 46 (f)(1) or (2)) with respect to the method of accounting for the investment credit for public utility property for ratemaking purposes. A public utility with public utility property to which section 167(1)(2)(C) applies has an additional option of a third election, section 46(f)(3). If an election under section 46(f)(1), (2), or (3) is made, it is irrevocable. If no election is made, section 46(f)(1) applies as if the taxpayer had elected to have the provisions of section 46(f)(1) apply.

The language of section 46(f)(2) of the Code demonstrates the integrated nature of the conditions set forth in subparagraphs (A) and (B) that will result in the disallowance of the credit if not avoided. In each subparagraph, the term "credit allowable" is used to describe that which may not be used to reduce cost of service faster than ratably as well as that which may not be used to reduce rate base in any manner. Thus, subparagraph (B), in prohibiting a

reduction in rate base "by reason of any portion of the credit allowable," and subparagraph (A), in limiting the reduction in cost of service to not more than "a ratable portion of the credit allowable," indicate that any credit, a ratable portion of which is used to reduce cost of service, must be included in rate base in order that there be no reduction in rate base as is required by subparagraph (B).

Additionally, the following House and Senate Committee Reports clarify that compliance with both subparagraphs (A) and (B) of section 46(f)(2) of the Code is to be determined by reference to "any accounting treatment" that can effect a reduction in cost of service or a reduction in rate base.

The language of the Committee Reports is as follows:

> In determining whether or to what extent a credit reduces cost of service, i.e., has been flowed through to income, reference is to be made to any accounting treatment that can affect cost of service. One usual method of flowing through the investment credit is to reduce the amount of Federal income tax taken into account. Another method of flowing through the investment credit is to reduce, by the amount of the credit, the depreciable basis of the property on the regulated books of account.
>
> In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect the company's permitted profit on investment. . . . H.R. Rep. No. 92-533, 92nd Cong., 1st Sess., at 26 (1971); S. Rep. No. 92-437, 92d Cong., 1st Sess., at 39 (1971).

With respect to the reduction in cost of service governed by section 46(f)(2)(A) of the Code, the above Committee Reports note at least two methods by which cost of service can be reduced for ratemaking purposes: (1) the usual method of reducing the Federal income tax element in cost

of service, and (2) an alternative method of reducing the depreciation expense element in cost of service by not including the investment credit in depreciable basis. It follows, therefore, that the use of more than one method to reduce cost of service would cause an aggregate reduction that could exceed the "ratable portion of the credit allowable" that is permitted under section 46(f)(2)(A).

Under the facts you have presented and our understanding of the ratemaking treatment of the investment tax credit prescribed in the Commission's Decision No. X for the years subsequent to the test year, there could be, in effect, a reduction in Pacific's [*General's*] cost of service for ratemaking purposes by more than a ratable portion of the credit and a reduction in its rate base by reason of a portion or all of the credit.

For the test year, under Decision No. X, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test-year. Such treatment would be consistent with the requirements of section 46(f)(2)(A) of the Code to avoid disallowance of the credit. The rate base included the qualified property investment (unreduced by the credit) that had generated the credit. Also, the depreciation expense in cost of service included depreciation on the qualified property investment (which had generated the credit) without any reduction in the depreciation basis of the property by any portion of the credit. Such treatment would be consistent with the requirement of section 46(f)(2)(B) that the rate base not be reduced by any portion of the credit allowable.

For the annual adjustment of rates after the test year, the application of Decision No. X requires an annual recalculation of the ratable portion of the investment tax credit (for reduction of the cost of service) to reflect anticipated investments in new property. There is no indication that this annual adjustment of rates (to reduce cost of service by a ratable portion of the credit allowable on anticipated

new investments) also includes an adjustment to rate base, depreciation expense, or other cost of service factors to reflect the resulting net increase of anticipated new investments over retirements from the rate base and depreciation base.

By not including an adjustment to rate base to reflect the net increase as a result of the anticipated new investments, the rate base will have been effectively reduced by reason of the credit generated by such new investments. Therefore, the failure to adjust the rate base to reflect the net increase as a result of the anticipated new investments would be in violation of section 46(f)(2)(B) of the Code because the rate base would be reduced by reason of the credit generated by the new investments. Further, by using an accounting treatment that does not include an adjustment to depreciation expense to reflect the net increase in the depreciation base from anticipated new investments that generated a credit, the cost of service would be considered to have been further reduced by reason of the credit, in violation of section 46(f)(2)(A) and the intent of Congress expressed in the Committee Reports.

Accordingly, should Decision No. X of the Commission become a final determination pursuant to section 46(f)(4), we believe that its application for the adjustment of rates in years subsequent to the test year would be inconsistent with the requirements of section 46(f)(2) of the Code and would result in Pacific's [*General's*] loss of eligibility for the investment tax credit under section 38.

Yours very truly,

/s/ John W. Holt
Director, Corporation Tax
Division

Nos. 78-606 and 78-607

In the Supreme Court of the United States

October Term, 1978

The Pacific Telephone and Telegraph Company,
Petitioner,
v.
The Public Utilities Commission of the State of California, and Robert Batinovich, Vernon L. Sturgeon, Richard D. Gravelle, Claire T. Dedrick, and William Symons, Jr., the members of said Public Utilities Commission, et al.,
Respondents.

General Telephone Company of California,
Petitioner,
v.
The Public Utilities Commission of the State of California, et al.,
Respondents.

JOINT APPENDIX FOR RESPONDENTS

California Public Utilities Commission, City & County of San Francisco, City of Los Angeles and City of San Diego.

THE JAMES H. BARRY CO. 170 SOUTH VAN NESS SAN FRANCISCO CA 94103

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APPENDIX A

[S.F. No. 22794. In Bank. Nov. 26, 1971.]

CITY AND COUNTY OF SAN FRANCISCO, Petitioner, v. PUBLIC UTILITIES COMMISSION et al., Respondents; PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

[S.F. No. 22793. In Bank. Nov. 26, 1971.]

CONSUMERS ARISE NOW et al., Petitioners, v. PUBLIC UTILITIES COMMISSION, Respondent; PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

(Consolidated Appeals.)

SUMMARY

At a time when a public utility had an option to, but did not, use accelerated depreciation on its federal tax returns, the Public Utilities Commission, for rate making purposes, imposed imputed accelerated depreciation with flow-through on it. The utility continued to use straight line depreciation and, before the instant rate making proceeding, the option was rendered unavailable to the utility by a federal tax law amendment. In the instant proceeding, the commission, in making its decision, noted that in the light of the unavailability of the option, it would be futile to consider the merits of adhering to the procedure adopted in the prior decision.

In proceedings to review, the Supreme Court annulled on the ground that the commission's refusal to consider the merits of adhering to the imputed acceleration with flow-through procedure constituted an abuse of discretion. The court observed that the commission could properly find that tax computations on the straight line basis involved an unreasonable expenditure arising out of an imprudent determination by the utility in not exercising the option when it was available, and that the decision, in its present form, gives the utility the benefit of acceler-

ated depreciation without flow-through, and, in effect, requires the ratepayers to contribute capital to the utility. (Opinion by Peters, J., expressing the unanimous view of the court.)

HEADNOTES

Classified to McKinney's Digest

(1) **Public Utilities and Services § 33—Basis of Rate Fixing—Income Tax as Expense.**—Income tax expense must be considered by the Public Utilities Commission in establishing a utility's cost of service in rate making proceedings.

(2) **Public Utilities and Services § 1—Public Utilities Act—Purpose.**—The primary purpose of the Public Utilities Act is to insure the public adequate service at reasonable rates without discrimination.

(3) **Public Utilities and Services § 33—Basis of Rate Fixing—Factors Considered — Disallowance of Expenses.** — The Public Utilities Commission has power to prevent a utility from passing unreasonable costs for materials and services onto the ratepayers by disallowing expenditures that the commission finds unreasonable.

(4) **Public Utilities and Services § 31—Rates or Charges for Services—Control Over Accounting Practices.**—The Public Utilities Commission has power to prevent a utility from resorting to accounting practices that result in unreasonably inflated tax expense.

(5a, 5b) **Public Utilities and Services § 33—Rates or Charges for Service—Basis of Rate Fixing—Factors Considered—Effect of Failure to Exercise Depreciation Option.**—In a proceeding involving determination of the cost of service of a utility which had used straight line depreciation but which had, in a prior decision by the Public Utilities Commission, been subjected to imputed accelerated depreciation with flow-through in recognition of an option in the federal tax laws, the commission abused its discretion in refusing to consider continuation of the accelerated depreciation procedure notwithstanding that the option had been rendered unavailable to the utility at the time of the instant proceeding by a tax law amendment, where the commission could not properly find that tax computations on the straight line basis involved an unreasonable expenditure resulting from an imprudent management determination by the utility in not electing to file on the basis of accelerated depreciation when it had an option to do so, and where the effect of the decision in the instant proceeding was to give the utility the benefit of accelerated depreciation without flow-through, and to require the ratepayers to contribute capital to the utility.

(6) **Public Utilities and Services § 32—Rates or Charges for Service—Fixing and Modifying Rates—Requiring Ratepayers to Provide Utility With Capital.**—Requiring ratepayers to put up the capital for a utility system is contrary to the basic principle of utility rate setting.

(7) **Public Utilities and Services § 32—Rates or Charges for Service—Fixing and Modifying Rates—Basic Principle.**—The basic principle of utility rate setting is to establish a rate will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use.

(8) **Public Utilities and Services § 33—Rates and Charges for Service—Basis of Rate Fixing—Factors Considered—Improper Tax Expenses.**—By permitting a utility to include in its cost a charge for federal taxes greatly in excess of its actual federal tax expense, the Public Utilities Commission deviated from the basic principle of utility rate settng calling for the establishment of a rate that will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use.

(9) **Public Utilities and Services § 32—Rates or Charges for Service—Fixing and Modifying Rates—Depreciation Procedure—Due Process.**—The continuation of imputed accelerated depreciation with flow-through for a utility, as adopted in a prior decision of the Public Utilities Commission rendered at a time when the utility had an option to, but did not, use accelerated depreciation on its federal tax returns, would not violate due process despite a subsequent federal tax law amendment rendering the option unavailable to the utility at the time of the instant decision, where the only effect of the amendment was to remove an option which the utility had already rejected, so that the effect of the continuation would be merely to require the utility to do that which it had freely chosen to do.

COUNSEL

Thomas M. O'Connor, City Attorney, Milton H. Mares, Deputy City Attorney, and William F. Bourne for Petitioner in No. 22794.

Garret Shean, in pro. per., and William M. Bennett for Petitioners in No. 22793.

Mary Moran Pajalich and Timothy E. Treacy for Respondents.

Warren A. Palmer as Amicus Curiae on behalf of Respondents.

Pillsbury, Madison & Sutro, John A. Sutro, Noble K. Gregory, George H. Eckhardt, Jr., and Richard W. Odgers for Real Party in Interest.

OPINION

PETERS, J.—These are consolidated proceedings to review Decision No. 77984 of the Public Utilities Commission of the State of California. The decision provides that the Pacific Telephone and Telegraph Company (Pacific) may use accelerated depreciation with the normalization method of accounting as defined in subsection *(l)* (2) (B) of section 167 of the In-

ternal Revenue Code and that, if it elects to do so, the commission, for rate making purposes, will compute Pacific's tax expense on the basis of straight line depreciation for the purpose of establishing its cost of service and will give recognition to the normalization tax reserve in determining rate base. The decision was made effective immediately.[1]

It appears that the general approach employed by the commission for determining what constitutes permissible rates is to determine for a "test period" the costs and expenses which can be attributed to providing the service, the rate base of the utility (value of property devoted to public use), and the reasonable rate of return to be allowed the utility on its rate base. The "test period" costs, expenses, and rate base are then adjusted to allow for the effect of various known or reasonably anticipated changes. By adding the adjusted costs and expenses to the rate of return (in recent years between 5 and 8 percent) multiplied by the rate base, as adjusted, the necessary gross revenues are determined, and the rates are then fixed to produce such gross revenues. (See *Pacific Tel. & Tel. Co.* v. *Public Util. Com.,* 62 Cal.2d 634, 643-645 [44 Cal.Rptr. 1, 401 P.2d 353].) Under this system an increase in a cost item will ordinarily be reflected as an increase in the rates, and a reduction in the rate base will produce a reduction in the rates. However, the increase in cost will be reflected in its full amount in the rates, while the reduction in the rate base will be reflected only to the extent of the reasonable rate of return, between 5 and 8 percent of the reduction.

In computing the cost of service for rate making purposes, the utility is allowed to recover its federal income taxes as a cost of business. In computing the federal income tax cost the utility is allowed to deduct depreciation, and the greater the depreciation for tax purposes (all other things being equal) the

1. The decision was by Chairman J. P. Vukasin, Jr., and was signed by Commissioners William Symons, Jr., and Vernon L. Sturgeon. Chairman Vukasin, Jr., also filed a concurring opinion. Commissioners Thomas Moran and A. W. Gatov dissented.

less the tax liability and the less the necessary rate to recover it.

Since 1954, the federal government has permitted straight line or accelerated depreciation in determining federal income tax liability. Straight line depreciation provides for essentially uniform annual write-offs of a depreciable asset over the life of the asset. Accelerated depreciation provides for larger allowances as expenses than straight line depreciation during the early years of the life of the asset but during later years the depreciation expense attributable to the asset will ordinarily be less than if the straight line method had been used. Because of the relation between depreciation and tax liability, it would follow in *theory* that accelerated depreciation would result in lower tax liability of tax expense in the early years as compared to straight line depreciation but that in subsequent years the tax liability would exceed that had straight line been used and thus lead to higher rates. In theory there would be lower rates in the earlier years under accelerated depreciation but higher rates in later years. However, in *practice*, the tax saving of the earlier years, although in a sense repaid in the subsequent years, does not result in higher taxes and rates in the later years because the utilities tend to increase their investment in plant and equipment every year so that the increased depreciation due to acceleration in any year will more than offset any reduced depreciation due to the effect of accelerated depreciation as to older assets.[2]

Apparently all utilities other than Pacific and General Telephone have used accelerated depreciation in computing and paying their federal income taxes. The commission has in the

2. In the language of the commission majority opinion: "Accelerated depreciation . . . provides for larger than straight-line annual write-offs of a depreciable asset during early years and diminishing annual write-offs during later years of the asset's life. For a given depreciable asset, the total amount written off duing its lifetime would be the same under either depreciation method but the rates of accruals would differ. For a group of assets of different vintages, the diminution of accruals for older plant can be obscured by the larger accruals on newer plant."

past required the utilities using accelerated depreciation to pass on the tax savings to the consumer in the form of lower rates (in computing the cost of service for the purpose of fixing rates, the actual tax liability was used rather than the greater tax liability that would have been due had straight line depreciation been used for tax purposes). This passing on to the consumer of the tax savings is called "flow-through."

Pacific and General Telephone, unlike other utilities, have refused to use accelerated depreciation in filing their income tax returns. On November 6, 1968, in Decision No. 74917 the commission determined that Pacific's management was imprudent in not electing to take accelerated depreciation for income tax purposes. The commission concluded that it could not compel Pacific to take the accelerated depreciation on its federal income tax return, but it held that for purposes of rate making Pacific would be treated as if it had obtained the tax saving of accelerated depreciation and that the saving would be flowed-through to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow-through.) Notwithstanding this, Pacific continued to determine its federal tax liability using straight line depreciation.

In section 441 of the Tax Reform Act of 1969, Congress amended section 167 of the Internal Revenue Code to limit the use of accelerated depreciation by utilitis in determining income tax liability. Subsection *(l)* (2) provides: "In the case of any post-1969 public utility property, the term 'reasonable allowance' [for depreciation] as used in subsection (a) means an allowance computed under—

"(A) a sbsection *(l)* method [straight line depreciation (see Int.Rev. Code, § 167, subs. *(l)* (3) (F))],

"(B) a method otherwise allowable under this section [such as accelerated depreciation] in the taxpayer uses a *normalization* method of accounting, or

"(C) the applicable 1968 method, if, with respect to its pre-

1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period."[3] (Italics added.)

Subsection *(l)* (3) (G) defines normalization: "In order to use a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purpose of establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The commission permitted argument by interested parties in this matter. However, it refused to accept any evidence and struck evidence previously received (some correspondence between Pacific and the Internal Revenue Service).

The commission found that it had in its 1968 decision imputed to Pacific for tax purposes accelerated depreciation with flow-through pointing out that Pacific had an option to use accelerated depreciation; that Pacific had used straight line depreciation in its income tax returns through the year 1969, and that under the Tax Reform Act of 1969 could accelerate depreciation for tax purposes only if it normalized. The commission concluded that it would now declare that it intended

3. All utilities other than Pacific and General Telephone, are eligible to come under clause (C) and thus continue to use accelerated depreciation for tax purposes with flow-through of the tax savings to the consumer. It would seem that Pacific and General Telephone may not resort to the option provided by clause (C) because they did not use accelerated depreciation in 1968 or in their July 1969 accounting period.

to use normalization of taxes in setting Pacific's rates so that Pacific could commence acceleration under subsection *(l)* (2) (B) with regard to its 1970 taxes.

The majority opinion reasoned that the commission could not continue the existing method of imputing accelerated depreciation. The commission said of its 1968 ruling: "The imputation of accelerated depreciation with flow-through did not deprive Pacific of its property without due process because there was then no legal restriction against Pacific's changing to accelerated depreciation with flow-through and paying essentially those income taxes that had been allowed in the decision. [¶] That no longer is the case. If we now were to attempt to impute accelerated depreciation with flow-through for setting rates in this proceeding, the law clearly would preclude Pacific from actually using accelerated depreciation in filing its federal income tax returns. We thus would be assuming lower taxes than Pacific would be required by law to pay. . . . *Since accelerated depreciation with flow-through is no longer an option available to Pacific under federal law, it would now be futile to consider the relative merits of flow-through and normalization.*" (Italics added.)

We have concluded that the commission has erred in refusing to consider the merits of adhering to the 1968 method of *imputing* accelerated depreciation with flow-through and that for this reason its decision must be annulled. Under the 1968 method Pacific filed its federal income tax return on the basis of straight line depreciation but for rate purposes the tax expense was calculated on the basis of accelerated depreciation and the savings flowed-through to the ratepayers. Subsection *(l)* (2) (A), quoted above, provides that the utility may use straight line depreciation in its federal income tax returns, and there are no conditions to the resort to straight line.

The commission and Pacific do not dispute that there are no conditions to the use of straight line depreciation in the subsection. Their position is that, if straight line depreciation is

used in fili[illegible] the income tax return, due process requires that its tax expense for rate-making purposes be its actual tax expense and that it would be a denial of due process to *impute* accelerated depreciation in computing its tax expense for rate making purposes.

(1) Income tax expense must be considered by the commission in establishing Pacific's cost of service. (See *Galveston Elec. Co.* v. *Galveston,* 258 U.S. 388, 399 [66 L.Ed. 678, 684, 42 S.Ct. 351]; *Dyke Water Co.* v. *Public Utilities Com.,* 56 Cal.2d 105, 127 [14 Cal.Rptr. 310, 363 P.2d 326].) **(2, 3)** However, "the primary purpose of the Public Utilities Act is to insure the public adequate service at reasonable rates without discrimination; and the commission has the power to prevent a utility from passing on to the ratepayers unreasonable costs for materials and services by disallowing expenditures that the commission finds unreasonable. (*Pacific Tel. & Tel. Co.* v. *Public Utilities Com., supra* 34 Cal.2d 822.)" (*Pacific Tel. & Tel. Co.* v. *Public Util. Com., supra,* 62 Cal.2d 634, 647.)

(4) The same rule applies where the utility resorts to accounting practices which result in unreasonably inflated tax expense. It was on the basis of this rule that the commission in 1968 determined to *impute* accelerated depreciation to Pacific in determining its tax expense. In Decision 74917, the commission stated that for the period 1954-1967 Pacific's taxes would have been $225,000,000 less if it had used accelerated depreciation for the entire period, and that in other words, "Pacific's ratepayers might have had to pay some $450,000,000 less if Pacific had availed itself of the lawful option of using accelerated depreciation for tax purposes. . . ."[4] If it had been

4. Apparently the commission assumed a 50 percent tax rate.

The fact that the necessary increase of revenue is approximately double the tax expense suggests the reason why Pacific refused to shift to accelerated depreciation with flow-through when it could do so.

On the other hand, there is substantial reason, other than benefit to its ratepayers, for a utility to voluntarily switch from straight line depreciation to accelerated depreciation with flow-through. Ordinarily there will be some period during which the utility pays reduced taxes on the basis of

using accelerated depreciation, the savings in the test year would have been $27,400,000 with a resultant savings effect on gross revenues of approximately $57,000,000. (69 Cal. P.U.C. 53, 61-62.) The commission found that a "true tax saving" will continue to result from accelerated depreciation for at least as long as plant additions equal or exceed plant retirements and pointed out that without exception Pacific's witnesses foresee a continuing growth of plant, one estimate involving a doubling of plant in 10 years and compounding of growth during the next 20 years.[5] (*Id.* at p. 62.)

The commission found that management's discretion has exceeded a reasonable and prudent course respecting income taxes to the detriment of the public interest and that it was fair and reasonable and in the public interest to compute Pacific's income tax expense for the test year on the basis of the use of accelerated depreciation beginning with plant additions in the test year. (*Id.,* at p. 90.)

(5a) Under its general power to prevent a utility from passing on to its ratepayers unreasonable costs, the commission in the instant proceeding, notwithstanding the change in the federal tax statute, could properly find that the federal income tax calculated on the basis of straight line depreciation involved an unreasonable expense and that the unreasonable expense due to such calculation was due to an imprudent management decision.

Although prior to the statutory change Pacific was free to change its method of accounting on its income tax returns but now may no longer do so, its inability to switch is due to its

accelerated depreciation before the commission adjusts rates to reflect the reduced payments. During that period the savings due to accelerated depreciation will inure to the benefit of the utility.

5. It should also be recognized that in the unlikely event the rate of investment should decrease, there could be a net increase in a given year but that so long as the utility remains a going concern and must continue with some investment there will be an overall tax saving while it continues accelerated depreciation. In other words, so long as there is a single dollar of new investment, there will be a tax deferral.

original imprudent determination to pay federal income taxes on a straight line depreciation basis and its obstinacy after the 1968 commission decision in adhering to the imprudent determination.

As pointed out in footnote 3, any utility which used a flow-through method of accounting for its July 1969 accounting preiod may continue to do so under clause (C) of subsection (2). There is no suggestion in the majority opinion or the two dissenting opinions that, if Pacific were eligeble for accelerated depreciation and flow-through in paying its federal taxes, Pacific would not be reqiured to compute its federal tax expense on such basis for rate making purposes.[6] It thus seems clear that the only reason it is not treated in this manner is that in prior years it imprudently refused to file returns on a basis of accelerated depreciation and then after the 1968 decision obstinately continued in its imprudent refusal.

The effect of Pacific's refusal in 1968 to switch to accelerated deprication was to cast a significant burden on itself. By refusing to switch to accelerated depreciation in filing its income tax returns after it was aware that such depreciation would be imputed to it for rate making purposes in calculating federal tax expense, Pacific in essence placed itself in the position of paying a large income tax bill, part of which was unnecessary and was not to be recovered in higher rates. As to that part, Pacific in a sense placed itself in the position of having to raise additional funds, either debt or investment. Nevertheless, Pacific chose to do so.

It should also be pointed out that the effect of the instant decision is to permit Pacific to include as an expense for rate making purposes a large amount of federal income taxes which it will not be required to pay in the foreseeable future. Although the majority opinion ignores this matter, the concurring opinion

6. The concurring opinion of Chairman Vukasin, Jr., suggests a contrary view.

and the two dissenting opinions recognize that accelerated depreciation and normalization will result in the ratepayers contributing capital to Pacific. As the concurring opinion points out, this method of accounting will "provide a source of interest-free capital." We do not know how much capital will be provided, but the dissenting commissioners estimate that the ratepayers in the next 10 years will have to provide between $750,000,000 and one billion dollars. Commissioner Moran in his dissenting opinion states that if the ratepayers are required to put up the capital for the telephone system, it "is indeed a step toward socialism and logically could lead ultimately only to government ownership of the telephone system. . . ."

(6) Although Commissioner Moran may be overstating the matter, it is clear that requiring ratepayers to put up the capital for the telephone system is contrary to the basic principle of utility rate setting. **(7)** The basic principle is to establish a rate which will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use. (*Pacific Tel. & Tel. Co.* v. *Public Util. Com., supra,* 62 Cal.2d 634, 644-645.) **(8)** By permitting Pacific to include in its costs a charge for federal taxes greatly in excess of its actual federal tax expense, the commission is deviating from this basic principle. We realize that the 1968 commission decision also deviated from the basic principle by refusing to permit Pacific to include in its costs all of its tax expense, but this deviation was based on Pacific's imprudent management.

(5b) It should also be pointed out that the effect of the instant decision is to reward Pacific for its imprudent management as compared to other utilities which prudently had adopted accelerated depreciation and flow-through prior to August 1969. Apparently, these utilities will continue to be required to flow-through the benefits of accelerated depreciation to the ratepayers, whereas Pacific will be allowed to use

accelerated depreciation without requiring flow-through, thus retaining most of the benefits for itself.

In the circumstances, we are satisfied that, in the light of Pacific's past imprudence, the commission could reasonably have ordered Pacific to continue the accounting practices established in the 1968 decision and that the commission abused its discretion in expressly *refusing to consider* imputed accelerated depreciation and flow-through as established in the 1968 decision.

(9) The argument that in the light of the federal tax amendment there will be a denial of due process in continuing the 1968 treatment falls on its face in view of Pacific's conduct. Prior to the federal tax amendment and after the 1968 decision of the commission, Pacific could have elected to change its accounting procedures in filing its returns and thereby saved substantial tax expense. Pacific, however, chose not to do so. The only effect of the federal tax amendment is to take away the option which Pacific had already rejected. Requiring Pacific to do that which it had freely chosen to do cannot be said to be a denial of due process. In other words, after the 1968 decision, Pacific, if it chose could have opted for accelerated depreciation on its tax return. It did not do so. Had it done so, Pacific could have uesd accelerated depreciation with flow-through. Now the option to switch to accelerated depreciation and flow-through has been terminated, but even assuming the absence of the option is a matter to consider by the commission, it does not mean that continuation of the 1968 treatment will result in a denial of due process.

For failure to consider lawful alternatives in calculation of federal income tax expense, the decision of the commission must be annulled. (Cf. *Northern California Power Agency* v. *Public Util. Com.*, 5 Cal.3d 370, 380 [96 Cal.Rptr. 18, 486 P.2d 1218].) Upon further consideration the commission should consider whether to adhere to the 1968 method of determining

federal income tax expense and whether to adopt the accelerated depreciation and normalization method adopted by the decision before us. Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax are either harsh on the utility or the ratepayers, the commission may also consider alternative approaches which strike a balance between these two extremes.

The 1968 method of imputed accelerated depreciation and flow-through is favorable to the ratepayer but harsh on Pacific. In terms of the 1967 figures, as compared to straight line depreciation for tax purposes, this method would save the ratepayer 54 million dollars but Pacific would in a sense be penalized 27 million dollars. The method adopted by the decision before us is harsh on the ratepayer who under the 1967 figures will be compelled to lose most of the 54-million-dollar saving but is beneficial to Pacific which will be permitted rates including the 54 million.

These two methods are extremes when compared to the nontelephone utilities which, having switched to accelerated depreciation with flow-through prior to 1970, may continue with that method and permit the ratepayers the consequent reduction without being compelled to pay the tax on the basis of straight line depreciation. Although the method open to the nontelephone utilities is not open to Pacific, the commission is not compelled to adopt one of the two extremes set forth above but may adopt a compromise striking a proper balance between the interests of the ratepayers and Pacific in the light of current federal income tax statutes.

Both of the extreme methods involve a fictitious change of federal tax expense. The 1968 method deliberately understates the actual tax expense on the basis of the imprudent management of Pacific. The method adopted in the decision before us deliberately overstates the actual tax expense in order to nor-

malize. Since a fictitious figure must be used under either method, it is not improper for the commission to use an additional fictitious factor to limit the harsh results. Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections.

The decision is annulled.

Wright, C. J., McComb, J., Tobriner, J., Mosk, J., Burke, J., and Schauer, J.,* concurred.

The petition of the real party in interest for a rehearing was denied December 23, 1971. Sullivan, J., did not participate therein.

[S.F. No. 23215. In Bank. Dec. 12, 1975.]

CITY OF LOS ANGELES et al., Petitioners, v.
PUBLIC UTILITIES COMMISSION et al., Respondents;
PACIFIC TELEPHONE AND TELEGRAPH
COMPANY, Real Party in Interest.

[S.F. No. 23237, 23257. In Bank. Dec. 12, 1975.]

CITY OF LOS ANGELES et al., Petitioners, v.
PUBLIC UTILITIES COMMISSION et al., Respondents;
GENERAL TELEPHONE COMPANY OF
CALIFORNIA, Real Party in Interest.

SUMMARY

In three telephone rate cases, the Public Utilities Commission determined that it lacked legal authority to approve tariffs which would annually adjust telephone rates to take account of changing federal tax expenses. It refused to consider its

*Retired Associate Justice of the Supreme Court sitting under assignment by the Chairman of the Judicial Council.

staff's recommendation of a rate setting system which included a formula by which rates would be automatically adjusted annually on the basis of savings to the utilities through their use of accelerated depreciation as permitted under federal tax law. Because of its determination that it could not adopt the annual adjustment plan, the commission stated that it was compelled to set a rate which would create a windfall for the telephone companies to the detriment of the rate payers.

The Supreme Court affirmed the commission's order except as to the portion relating to treatment of tax expenses, and as to that portion it annulled and remanded the matter for further proceedings consistent with the opinion. The court held that the commission possesses the power to implement an annual adjustment scheme. In rejecting a contention that such a system was precluded by Pub. Util. Code, § 728, which provides that the commission "after a hearing" may adjust improper "rates, classifications, rules, practices, or contracts," the court held erroneous the conception that a "rate" is a single set of unvarying fixed charges, and that a "hearing" must occur before each variation in those charges. It was pointed out that the commission's position was contrary to its long standing and unchallenged practice of including adjustment clauses in power company tariffs to take care of disproportionate variations in fuel costs as well as to judicial precedent and the purpose behind the statute's hearing requirement, which is to air the policy considerations behind various rate proposals and to establish controverted facts. In further holding that use of a tariff involving an annual adjustment does not deny due process to an affected utility, the court pointed out that a full hearing is required before the promulgation of any general rate tariff, that the utilities involved have the opportunity at that time to inspect and challenge any formula proposed through testimony, briefs, exhibits, and oral argument, that such an adjustment clause would operate on figuers which the utilities had placed in their account books, in accordance with a system

as to which they had received another, prior hearing, and with full knowledge that the commission would employ them in connection with the annual adjustment clause, and that an affected company is entitled to apply for a rate increase pursuant to Pub. Util. Code, §§ 454, 455, should application of the adjustment clause result in a rate below its authorized return. (Opinion by Tobriner, J., expressing the unanimous view of the court.)

HEADNOTES

Classified to California Digest of Official Reports, 3d Series

(1a, 1b) **Public Utilities § 11—Public Utilities Commission—Bases of Rate Fixing—Factors Considered—Validity of Automatic Annual Adjustment Clause.**—In telephone rate setting proceedings, the Public Utilities Commission erred in determining that consideration of a system of yearly automatic rate adjustments to take account of changing federal tax expenses of the affected companies was precluded by Pub. Util. Code, § 728, which provides that the commission "after a hearing" may adjust improper "rates, classifications, rules, practices, or contracts." Construing the statute to mean that a "rate" is a single set of unvarying fixed charges, and that a "hearing" must occur before each variation in those charges is unwarranted and is contrary to the commission's long standing and unchallenged practice of including adjustment clauses in power company tariffs and to judicial precedent. Moreover, the purpose behind the statute's heading requirement is to air the policy considerations behind various rate proposals and to establish controverted facts, and such purpose is not served by a hearing at which the only business at hand is the application of a mathematical formula to a figure definitively established by reference to the utilities' books.

(2) **Statutes § 44 — Construction — Aids — Contemporaneous Administrative Construction.**—Consistent administrative construction of a statute over many years, particularly when it originated with those charged with putting the statutory machinery into effect, is entitled to great weight and will not be overturned unless clearly erroneous.

(3a, 3b) **Public Utilities § 11—Public Utilities Commission—Bases of Rate Fixing—Factors Considered—Validity of Automatic Annual Adjustment Clause.**—In telephone rate setting proceedings, the Public Utilities Commission was not precluded by the due process clause of the United States Constitution from considering a system of yearly automatic rate adjustments to take account of changing federal tax expenses of the affected telephone companies. At the full hearing required by Pub. Util. Code, § 728, before the promulgation of any general rate tariff, the utilities involved have the opportunity through testimony, briefs, exhibits, and oral argument to inspect and challenge any formula proposed, and such an adjustment clause would operate on figures which the utilities had placed in their account books, in accordance with a system as to which they had received another, prior hearing, and with the full knowledge that the commission would employ them in connection with the annual adjustment clause. In addition, an affected company is entitled to apply for a rate increase pursuant to Pub. Util. Code, §§ 454, 455, should application of the adjustment clause result in a rate below its authorized return.

[See **Cal.Jur.2d,** Public Utilities and Services, §§ 28, 59; **Am.Jud.2d,** Public Utilities, § 266.]

(4) **Public Utilities § 10—Pbulic Utilities Commission—Fixing or Modifying Rates—Due Process.**—Within the context of public utility rate regulation, due process is a flexible concept, permitting expert administrative agencies broad latitude in adapting the specific regulatory needs of their jurisdictions.

(5) **Public Utlities § 10—Public Utilities Commission—Fixing or Modifying Rates — Due Process.** — The due process clause of the United States Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom such legislative power has been delegated are free, within the ambit of their statutory authority, the make the pragmatic adjustments which may be called for by particular circumstances, and once a fair hearing has been given, proper findings made, and other statutory requirements satisfied,

the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped.

(6) **Public Utilities § 16—Public Utilities Commission—Orders of Commission—Rehearing.**—The procedure of the Public Utilities Commission in entering an order on rehearing pursuant to Pub. Util. Code, § 1736, of a telephone rate setting proceeding, which repromulgated a tariff as an interim rate subject to refund if it were later found to be erroneous, was proper, though the commission erred substantively in failing to consider a system of yearly automatic rate adjustments to take account of changing federal tax expenses of the affected companies, where the time limit for a rehearing specified by Pub. Util. Code, § 1731, had not expired and the rate set by the commission's original decision had not become final and lawful so as to preclude refunds.

[See **Cal.Jur.2d,** Public Utilities and Services, § 123.]

COUNSEL

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OPINION

TOBRINER, J.—In these three telephone rate cases the Public Utilities Commission determined, inter alia, that it lacked legal

authority to approve tariffs which would annually adjust telephone rates to take account of changing federal tax expenses. As a consequence, the commission found itself compelled to set a rate which, in its own words, would "create a windfall for [the telephone companies] to the detriment of the ratepayers." (*Re Pacific Telephone & Telegraph Co.* (1974)—Cal.P.U.C.—(Decision No. 83162; slip opn., p. 63).) The commission took this action in spite of our having annulled its previous decisions in this matter "[f]or failure to consider lawful alternatives in calculation of federal income tax expense." (*City and County of San Francisco* v. *Public Utilities Com.* (1971) 6 Cal.3d 119, 130 [98 Cal.Rptr. 286, 490 P.2d 798].) As we explain, we have concluded that the commission does possess the power to implement an annual adjustment scheme, and we accordingly remand these cases in order that the agency may reconsider its action with knowledge of the full scope of its powers.

In addition to this failure to consider lawful alternatives in the treatment of tax expenses, the petitioning cities assert as grounds for annulment: (1) that the commission authorized an unreasonably high rate of return for the two telephone companies in question; and (2) that the commission erred in promulgating an interim rate pending its rehearing of the General Telephone case. As to the first contention, we have concluded that the commission did not exceed the boundaries of its discretion. (Pub. Util. Code, § 1757.) As to the second contention, we show below that the commission regularly pursued its authority.

1. *The background of the present litigation.*

Because these cases spring from the relationship between federal taxing authority and public regulatory power, we must review pertinent developments in these two fields.

An extremely significant element of the operating expenses which a rate-setting agency must consider is that of state and

federal taxes;[1] increased tax deductions decrease a utility's tax bill and with it the revenue it must acquire from its ratepayers. These cases turn on two such tax deductions available to General and Pacific,[2] accelerated depreciation and the Job Development Investment Credit;[3] both of them enable a public utility to reduce its tax expenses, and the efforts of regulatory bodies to pass the benefits of such reduced tax expenses on to the utilities' ratepayers form the backdrop to the instant cases.[4]

Such regulatory efforts are of course mandatory for a state agency charged with insuring that "[a]ll charges demanded or received by any public utility . . . shall be just and reasonable" (Pub. Util. Code, §451) and that "[n]o public utility shall raise any rate . . . except upon a showing before the commission and a finding by the commission that such increase is justified" (Pub. Util. Code, § 454). We therefore examine the background of these cases to determine whether the commission has failed to consider alternative means of dealing with unnecessary tax payments which might be eliminated to the benefit of the ratepayers.

Since 1954, section 167 of the Internal Revenue Code has given business taxpayers several options in computing depreciation deductions from their federal taxes. Thus the utilities in the instant case may, like other businesses, assume that their

1. According to one authority, as of 1967 United States telephone companies spent 23 percent of their total revenue on taxes. (Welch, Cases, Text, and Material on Public Utility Regulation (rev. ed. 1968) p. 440.)

2. We refer in this opinion to the real parties in interest in the instant case, General Telephone Company of California and Pacific Telephone and Telegraph Company, as General and Pacific, respectively.

3. The Job Development Investment Credit (85 Stat. 503, 26 U.S.C. § 46 et seq.), a tax deduction which all parties concede has tax and revenue effects substantially similar to accelerated depreciation and therefore calls for identical treatment, will be included in all subsequent references to accelerated depreciation.

4. In the instant Pacific proceeding the commission indicated that for *1973 alone*, "the difference in gross revenue requirements between" a rate passing tax benefits on to the consumer and one permitting the utilities to retain these benefits "is approximately $23 million." (*Re Pacific Telephone & Telegraph* (1974)—Cal. P.U.C.—, —(Decision No. 83162, slip opn., p. 7).)

depreciable assets wear out at an even rate and deduct the same amount of depreciation for each year of useful life; such an assumption is known as "straight-line" depreciation. Another option, first made available by 1954 amendments to the Internal Revenue Code is "accelerated" depreciation (Int. Rev. Code of 1954, § 167(b) (2)-(4)); using this method the enterprise takes deductions as if the asset in question depreciates more rapidly in the earlier years of its life and more slowly thereafter.[5] A taxpaying utility using accelerated depreciation would deduct the same *total* amount of depreciation over the useful life of the asset as a taxpayer using straight-line methods, but accelerated depreciation permits the largest part of this total to be deducted in the early years of the asset's life.

If one thinks of a single piece of depreciable equipment, such as a desk or typewriter, over the long run it would make no difference which system of depreciation were employed since the utility could write off no more than the total value of the asset in any case. That which holds true for a single asset, however, does not do so for an enterprise considered as an evolving whole. (Bonbright, Principles of Public Utility Rates (1961) pp. 218-223; see *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Com'n.* (5th Cir. 1966) 359 F.2d 318, 328.)

Ratemakers have discovered that if the total enterprise is either expanding or stable, the use of *accelerated depreciation does not merely defer taxes, but eliminates them entirely.* (See *FPC* v. *Memphis Light, Gas & Water Div.* (1972) 411 U.S. 458, 460 [36 L.Ed.2d 426, 430, 93 S.Ct. 1723]; Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation Under Section 167* (1956) 69 Harv.L.Rev. 1096, 1102.) This effect occurs because in the later years of an asset's life (when

5. In fact, the code and Treasury Regulations permit several different forms of accelerated depreciation, the differences between which are not here relevant; *all* forms of accelerated depreciation result in a deduction larger than that permitted by straight-line methods in the earlier years of the asset's life.

its value as a depreciation deduction has been used up), its place is taken by a *new piece of equipment, which replaces it as a deduction in income tax calculation.* This replacement effect means that the higher depreciation taken in early years does not have to be paid for by lower depreciation in later years; *the tax never catches up.* The result is a net tax savings to any utility using accelearted depreciation.[6]

For a rate-setting agency the comprehension of this counter-intuitive fact has important implications. If the Public Utilities Commission in setting rates were to assume that tax deductions for depreciation under both the straight-line and accelerated methods would yield the same result in the long run, it would, in fact, award the utility a rate windfall. For it would have set rates as if the utility would incur tax expenses *which it would never have to pay.*

In 1960 the California Public Utilities Commission after studying this problem issued a report indicating that it would pass on to ratepayers any savings effected by the adoption of accelerated depreciation and suggesting that the utilities' management elect this method. (*Commission Investigation Regarding Rate Fixing Treatment for Accelerated Amortization and Depreciation for all Utilities,* 57 Cal. P.U.C. 598.)[7]

6. A respected federal appellate judge has explained the apparently paradoxical tax savings as follows: "Lifetime depreciation on a single item of property is of course the same whether the utility elects straightline or accelerated depreciation. Under conventional accounting principles, therefore, the full amount of the value of the item less salvage would be a deductible expense. Conventional accounting, however, does not take consideration the effect of applying liberalized depreciation to a utility's total assets which are, of course, subject to a continuing cycle of obsolescence and renewal. If the industry is stable or expanding, requiring the utility's *continued reinvestment in plant equal to or in excess of plant retirement,* a program of liberalized depreciation produces true tax savings because there is no reduction in the tax reserve fund [fn. omitted]." (*Alabama-Tennessee Natural Gas Co.* v. *Federal Power Com'n., supra,* 359 F.2d 318, 328 (Wisdom, J.); italics in original.)

The United States Supreme Court has explained that the effect described by Judge Wisdom occurs bcause "the depreciation allowances from additional and replacement equipment offset the declining depreciation allowance on existing property." (*FPC* v. *Memphis Light, Gas & Water Div., supra,* 411 U.S. 458, 460 [36 L.Ed.2d 426, 430]; see also Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation Under Section 167* (1956) 69 Harv.L.Rev. 1096, 1102.)

Pursuant to this recommendation "[a]pparently *all utilities other than Pacific and General Telephone* have used accelerated depreciation." (*City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 124; italics added.) Because "Pacific and General Telephone, unlike other utilities . . . refused to use accelerated depreciation . . . [o]n November 6, 1968, in Decision No. 74917 the Commission determined that Pacific's management was imprudent" in not electing the option and "concluded that . . . for purposes of rate making Pacific would be treated as if it had obtained the tax saving of accelerated depreciation and that the saving your be [passed on] . . . to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow-through.)" (*Id.*)[8]

In 1969, however, Congress amended the Internal Revenue Code.[9] The amendments, some of a highly technical nature, provided that utilities which had not taken accelerated depreciation before 1969 could do so subsequently only if they "compute[d] tehir cost of service, which includes federal income taxes, as if they were using straight-line depreciation. This

7. Economists recognize that accelerated depreciation, when combined with flow-through accounting, encourages timely replacement of needed capital equipment (Defliese, *Changing Accounting Objectives — What About Utilities?* (1972 No. 2) 90 Pub. Util. Fort. 17, 20-21) in the extremely capital-intensive public utility industry (Rudolph, *Depreciation and Changing Price Levels: Specific Problems of Utilities,* in Depreciation and Taxes (Tax Inst. ed. 1959) pp. 80, 80-81) and permits obsolescence to be recognized before rather than after the fact "so that consumers will reap the benefits of progress that much sooner." (Defliese, *supra,* at p. 21.)

8. The commission's ruling corresponded with the conclusions reached by Swiren, *Accelerated Depreciation Tax Benefits in Utility Rate Making* (1961) 28 U. Chi. L. Rev. 629, 632: "The public interest requires that utilities maintain their costs at the lowest level consistent with proper service to the consumer. Accordingly, if the flow-through theory is sound and the reduction in current taxes is a permanent saving, *utilities should be required to utilize that procedure.*" (Italics added.)

9. Internal Revenue Code of 1954, section 167(*l*), as amended December 30, 1969; see *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 125.

method, referred to as 'normalization,'[10] was designed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation. If a utility used accelerated depreciation in determining its actual tax liability, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes was required to be placed in a deferrd tax reserve account. See *Amere Gas Utilities Co.*, 15 FPC 760." (*FPC* v. *Memphis Light, Gas & Water Div., supra,* 411 U.S. 458, 460 [36 L.Ed.2d 426, 430].) After the passage of these laws Pacific and General reversed their longstanding opposition to accelerated depreciation and began to take the larger deductions it authorized; they contended, however, that if the commission passed on to the ratepayers any of the savings thereby achieved, "degradation of service and possible financial collapse" would result and the utilities would "go bankrupt."[11]

In the wake of these developments a divided Public Utilities Commission decided that it "could not continue the existing method of *imputing* accelerated depreciation" to the utilities (*City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 125; italics added) and therefore that "it would now be futile to consider' " other methods benefitting the ratepayer because normalization was the only available alternative. (*Id.*, at p. 126.) We annulled.

In a unanimous opinion we held that the commission had

10. Internal Revenue Code of 1954, section 167*(l)*(3)(G), as amended December 30, 1969. As we explained in *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 128: "Although the majority opinion [of the commission] ignores this matter, the concurring opinion and the two dissenting opinions [of the commission] recognize that accelerated depreciation and normalization will result in the ratepayers contributing capital to Pacific. As the concurring opinion points out, this method of accounting will 'provide a source of interest-free capital.' We do not know how much capital will be provided, but the dissenting commissioners estimate that the ratepayers in the next 10 years will have to provide between $750,000,000 and one billion dollars."

11. The commission rejected these contentions abstaining from passing the tax benefits of accelerated depreciation on to the ratepayers only because of its doubts about its legal power to do so.

not regularly pursued its authority in failing "to consider lawful alternatives in calculation of federal income tax expense." (*Id.*, at p. 130.) Specifically, we ruled that the commission should consider alternatives, which, while taking into account "the imprudent management"[12] of the real party in interest, might serve as "a compromise striking a proper balance between the interests of the ratepayers and . . . [real party in interest] in the light of current federal income tax statutes." *(Ibid.)* The instant case arises from the commission's action on remand.[13]

Following our annullment of its decisions in *City and County of San Francisco* and *City of Los Angeles,* the commission held new hearings. In the case of Pacific we had annulled a final rate,[14] and the commission therefore held entirely new ratemaking proceedings, considering each aspect of revenue and expenses anew. General's case involved an additional factor; as we set forth in the margin, the commission considered appropriate ratemaking treatment of tax expenses for General in two separate proceedings, once in a limited rehearing of a

12. In the case from which we quote, the phrase referred exclusively to Pacific, but, as we have subsequently pointed out, it might apply equally to General: "Apparently all utilities in California except Pacific and General Telephone follow accelerated depreciation with flow through.... Pacific and General Telephone have apparently in the past used straight line depreciation." (*City of Los Angeles* v. *Public Utilities Commission* (1972) 7 Cal.3d 331, 338-339, fn. 2 [102 Cal. Rptr. 313, 497 P.2d 785]; cf. *Re General Telephone Co. of Cal.* (1974)—Cal.P.U.C.—Decision No. 83778,pp, 23, 39).)

13. Because we held that the commission's failure to consider lawful alternatives in tax treatment was error, and because we subsequently found that this and other errors could not be severed from the remainder of the rate, we annulled the entire Pacific rate. (*City of Los Angeles* v. *Public Utilities Commission* (1972) 7 Cal.3d 331 [102 Cal.Rptr. 313, 497 P.2d 785].) As noted below (fn. 15, *infra*) the commission, perceiving that the Pacific and General cases involved identical legal issues, reheard the General case. Thus, although strictly speaking, "remand" was involved only in the Pacific case, the commission reconsidered both cases, and we now have before us the results of that reconsideration.

14. See *City of Los Angeles* v. *Public Utilities Commission, supra,* 7 Cal.3d 331, 354-359.

rate case contemporaneous with the annulled Pacific decision,[15] and once in hearings held pursuant to a new rate increase request by General.[16] Because all three of these proceedings reached substantially identical treatments of the tax expenses in question by a substantially identical procedural route, we shall describe them as a single proceeding, noting divergences only when necessary.[17]

The commission focused most of its attention on a staff proposal somewhat awkwardly styled "pro forma normalization." Stated briefly, this proposal involves an accounting adjustment which takes account of the fact that the deferred tax reserve (an asset) is much lower at the start of the ratemaking period than it will be after the effects of accelerated depreciation accumulate.[18] The staff plan called for a reduction in the rate

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15. At the time we filed *City and County of San Francisco* v. *Public Utilities Commission, supra*, 6 Cal.3d 119, the commission had just granted General a rate increase based in part upon the same treatment of accelerated depreciation which we found unlawful in *City of Los Angeles* and *City of San Francisco*. (*Re General Telephone Co. of Cal.* (1971) 72 Cal. P.U.C. 652.) Recognizing that the same legal issue controlled both the Pacific and General rates, the commission in response to petitions by the Cities of Los Angeles and Long Beach granted rehearing. (*Re General Telephone Co. of Cal.* (1971) 72 Cal.P.U.C. 725; *Re General Telephone Co. of Cal.* (1972) 72 Cal. P.U.C. 795.) These orders continued in effect the rates promulgated before *City of Los Angeles* was filed, but made them subject to refund if the commission subsequently found them unjustified. (We consider *infra* at pp. 705-707 the propriety of the interim order and the rates established by it.)

16. *Re General Telephone Company of Cal.* (1975)—Cal. P.U.C.—(Decision No. 83779).

17. The commission's most elaborate and most complete response to the problem and to our order on annulment occurs in its decision in the Pacific case (Decision No. 83162). While considerable discussion is devoted to the topic in the limited rehearing of the General case (Decision No. 83778), the commission staff had at the time of hearing of that matter not yet fully developed its alternative proposals. The two General cases (Decisions Nos. 83778 and 83779) were filed after the Pacific proceeding and rely heavily on it; the Pacific decision (No. 83162) thus becomes the key commission response.

18. As we have noted, the crucial fact about this deferred tax reserve is that it is a misnomer; unlike other deferred reserves, this one represents not a putting-aside for expenses which will later be encountered, but a *permanent savings*. (See fn. 6, *ante*, and text thereto.) Moreover, the utility can earn interest on this reserve and, unless some adjustment is made, will earn a return from ratepayers on it.

base (on which return is calculated) to reflect what is, in effect, an additional source of revenue for the utilities.[19] The commission, however, rejected pro forma normalization on the grounds that it would violate the provisions of the Internal Revenue Code and of a Treasury Regulation interpreting it.[20]

With its attention thus concentrated on the primary staff proposal and Pacific's and General's vigorous objections to it, the commission gave only cursory consideration to another proposal, known as "annual adjustment."[21] The record indicates that the hearing examiner suggested to the parties that the feasibility of a system of yearly automatic rate adjustment be investigated. The staff witness accordingly prepared exhibits and testified at some length concerning this rate setting system.[22]

While technical in its application, the concept of an annual

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19. In order to effect this adjustment withuot running afoul of the new Internal Revenue Code restrictions, the staff proposed to hold the rate of return "even," but to decrease the *rate base*. Pro forma normalization accomplishes this result by substituting for the deferred tax reserve of the *historical* test year which the commission uses to set rates, a figure based on projections of *future* accumulations of this reserve.

20. While the commission's proceedings in the instant cases were pending the Treasury promulgated a series of regulations which in the commission's view, precluded pro forma normalization. (Treas. Reg. § 1-167 (*l*)-1(*h*)(6) (1974).) We here reiterate that in view of our disposition of these cases, we express no opinion regarding the validity of the regulation as an interpretation of section 167 of the Internal Revenue Code of 1954 (cf. *Arkansas-Oklahoma Gas Co.* v. *Commissioner of Int. Rev.* (8th Cir. 1953) 201 F.2d 98, 102; Mertens, The Law of Federal Income Taxation (rev. ed. 1974) § 3.21, p. 46), the constitutionality of the regulation as an infringement of the powers reserved to the states under the federal Constitution (U.S. Const., Amend. X), or the continued availability of pro forma normalization (cf. fn. 42, *infra*).

21. The commission devoted a scant ten lines to its discussion of annual adjustment in its original decision in the Pacific case (Decision No. 83162) and supplemented this consideration with but three additional sentences on denial of rehearing (Decision Nos. 83540). Mention of this opinion on denial of rehearing makes it appropriate to indicate at this point that the commission neither violated the statutes governing its procedures nor trespassed on its discretion in supplementing its opinion upon denial of rehearing. (Pub. Util. Code, §§ 1708, 1736.) Petitioners' contentions to the contrary are meritless.

22. At the request of Hearing Examiner Barnett the staff witnesses developed the requested information. Their testimony and cross-examination by various parties covers more than 50 pages of reporter's transcript. In addition they submitted some 20 supplemental pages of explanation in the form of exhibits.

adjustment is essentially simple: the rate established by the commission includes a formula which, when applied each year to figures in the utilities' accounts, produces appropriate adjustments in rates to keep them in step with the company's changing financial situation.[23] In the case of annual adjustment to reflect the growing deferred tax reserves, the *actual* amount of the reserve accumulatd by the utility would be compared with the amount used in the test year on the basis of which the commission set rates.[24] As the reserve grew, the formula would effect a corresponding reduction in the rate base to take account of this new source of investment capital.

The effect of annual adjustment in some respects resembles that which would occur if the commission each year conducted a new rate proceeding in which all factors except that of tax reserve held constant. In such a case the commission would look to the tax reserve as the sole relevant variable and reduce the rate base to compensate for tax reserve accumulations. As long as the commission's policy towards the tax reserve accumulations remained unchanged, however, such yearly proceedings would reduce themselves to substantially ministerial steps.[25] In similar circumstances the commission has concluded

23. For more than three years, subsidiaries of the Bell System providing telephone service in Illinois, New Jersey, and Canada have *sought* "automatic" adjustment clauses to enhance utility productivity and compensate for price and cost fluctuations (Kendrick, *Efficiency Incentives and Cost Factors in Public Utility Automatic Revenue Adjustment Clauses* (1975) 6 Bell J. Econ. 299, 304-309 [hereafter cited as Kendrick]).

24. In fact, the staff witness suggested two forms of annual adjustment. In one, known as January 1st adjustment, the commission would employ the estimates of tax reserves on the company's books at year end to make its adjustment; in the other form, the commission would wait until the following October, at which point the final figures would be in, before making the adjustment. The disadvantage of the October method flows from the nine-month lag in rate relief, a lag whose effect is cumulative; the advantage of the October clause is that it is based on final figures ascertainable after the company's books have been audited. We perceive no statutory or constitutional significance to flow from the difference between these two methods, and what we say below applies equally to both of them.

25. As in the case of "automatic" adjustment clauses for productivity and price fluctuations (Kendrick, *supra*, at pp. 306-309), the regulatory commission's primary function should be to gather empirical data periodically on changes on each utility's tax reserve accumulations and then apply relevant data to the adjustment formula.

that the promulgation and periodic application of an adjustment formula more effciently implements its policy.

The commission thus employs adjustment clauses when it encounters an item of expense or revenue which tends to vary abnormally in comparison to the utility's other financial data; fuel cost adjustment clauses, which the commission presently inserts in the tariffs of power companies, constitute a prominent current use of such clauses. The commission's staff experts testified that the rapidly accumulating tax reserves presented an anomalous factor in the telephone companies' financial profile similar to that posed by the fuel costs of the power companies.[26]

The commission accepted this analysis, explaining that: "One consequence of the use of accelerated depreciation by Pacific is to create a rapidly growing reserve for deferred taxes that is totally out of consonance with the roughly harmonious relationship between revenues, expenses, and rate base." (*Re Pacific Telephone* (1974)—Cal.P.U.C.— Decision No. 83162, slip opn. 63); accord, *Re General Telephone Company of California* (1974)—Cal.P.U.C.—(Decision No. 83778, slip opn., p. 24).)

In spite of the applicability of the usual justifications for annual adjustment clauses to the instant cases, however, the commission without consideration rejected its staff's recommendation that such clauses be made a part of the tariff in the event flow-through and pro forma normalization were re-

26. In the words of the staff witness who explained the mechanics of annual adjustment: "As I have testified and demonstrated both in an earlier phase of this proceeding and in the reopened proceeding of General Telephone Company . . . , the growth of the deferred tax reserve *far exceeds the normal growths of revenue, expenses, and rate bases, which tend to grow proportionately*. . . . The rates of most California utilities are set on the basis that revenues, expenses, and rate base will grow somewhat in *proportion* and these same utilities have no reserve as they are on flow through. For a normalization company like Pacific, the rate base *cannot grow as fast as it normally would* because the deferred tax reserve is displacing investment which would come from stock or bondholders for a straight line or flow through company." (Italics added.)

jected.[27] The commission explained its refusal to consider annual adjustment clauses in the following terms: "Nor will we consider further the automatic adjustment clause. This method was proposed with the understanding that the commission would consider it only if Pacific consented to its imposition; Pacific has not consented." (*Re Pacific Telephone and Telegraph Company* (1974) — Cal.P.U.C. — (Decision No. 81362, slip opn. p. 59).)

Elaborating on this somewhat cryptic statement[28] in its opinion on denial of rehearing, the commission indicated that its refusal to consider annual adjustment stemmed from its belief that "Any order which would have the effect of automatically reducing the rates of any utility without hearing and without the opportunity for hearing would be inconsistent with the Public Utilities Code unless the consent of the utility was first obtained. Our rejection of the automatic reduction method stems not from any undue consideration for Pacific but from a due regard for statutory limitations."[29] (*Re Pacific Telephone and Telegraph Company* (1974)—Cal.P.U.C.—(Decision No. 83540, slip opn. p. 10).) We must therefore examine the legal bases of the commission's refusal to entertain the system proffered by its staff.

27. The staff witness indicated that annual adjustment ranked just behind pro forma normalization as a desirable alternative to normalization, which was the plan proposed by the utilities.

28. Neither the real parties nor the commission has indicated the origin of the "understanding" to which the decision refers; any such understanding would in any case be irrelevant in light of our order on annulment to consider "alternative approaches" to the problem which accelerated depreciation posed for ratemakers. (*City and County of San Francisco, supra,* 6 Cal.3d 119, 130.) Parties may not by consent disregard directions of this court.

29. In so ruling the commission seemingly assumed that annual adjustment conformed to Internal Revenue Code of 1954 section 167, subdivision (*l*) (3) (F) and Treasury Regulation, section. 1-167(*l*). Since the instant cases, of course, do not squarely present the question of the congruence of annual adjustment and the Internal Revenue Code, we do not address the issue. We note in passing that in concept, annual adjustment closely approximates annual ratemaking, and the Internal Revenue Code does not, of course, forbid such a procedure. (See Treas. Reg. § 1-167(*l*)-1(h) (6) (ii).)

2. *The Public Utilities Commission failed regularly to pursue its authority in refusing to consider annual adjustment as an alternative rate setting system.*

The commission in these cases operated under a dual obligation to weigh and explain its actions in regard to the treatment of accelerated depreciation. First, it acted, as always under the statutory obligations of insuring that all utility rates are just and reasonable (Pub. Util. Code, § 451), that no utility raises its rates unless the commission finds the increase justified (Pb. Util. Code, § 454), and that its decision "contain[s], separately stated, findings of fact and conclusions of law . . . on all issues material to the order or decision" (Pub. Util. Code, § 1705).[30]

In addition to these continuing statutory duties, the commission in the instant case was also bound by our order in *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, in which we annulled a tariff for the commission's "failure to consider lawful alternatives in calculation of federal income tax expense" (*id.,* at p. 130), and in which we indicated that the commission should consider available alternatives. Thus the commission labored under a two-fold obligation thoroughly to deliberate upon methods of dealing with a problem it had perceived.

In spite of these statutory and judicial obligations, however, the commission failed to consider an annual adjustment provision, a plan suggested by its hearing examiner, testified to by its staff, concerning which full cross-examination had occurred, and which, on the face of the record, appeared capable of rela-

30. As Justice Traynor emphasized in the leading case construing the requirement of specific findings, a requirement added to the statute in 1961: "Even when the scope of review is limited, . . . findings on material issues enable the reviewing court to determine whether the commission has acted arbitrarily. . . . Findings on material issues can also serve to help the commission avoid careless or arbitrary action. . . . There is no assurance that an administrative agency has made a reasoned analysis if it need state only the ultimate finding . . . ." (*California Motor Transport Co.* v. *Public Utilities Com.* (1963) 59 Cal.2d 270, 274-275 [28 Cal.Rptr. 868, 379 P.2d 324].)

tively easy implementation. Speaking of a similar failure to consider relevant aspects of a decision, we recently explained "[t]he Commission may and should consider *sua sponte* every element of public interest affected by . . . [utility proposals] which it is called upon to approve. It should not be necessary for any private party to rouse the Commission to perform its duty. . . . Thus, we conclude that the Commission failed to give adequate consideration to the . . . issues . . . and that its decision must be annulled." (*Northern California Pawer Agency* v. *Public Util. Com.* (1971) 5 Cal.3d 370, 380 [96 Cal. Rptr. 18, 486 P.2d 1218]; accord, *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119; *City of Los Angeles* v. *Public Utilities Commission, supra,* 7 Cal.3d 331.) If, as we have shown, unjustified failure to deliberate constitutes error, we must consider the grounds which the commission has proffered as justification of its refusal to consider annual adjustment.

In explaining its action the commission indicated that discussion of an annual adjustment clause would serve no purpose because Public Utilities Code section 728, which requires a "hearing" before the promulgation of rates placed beyond its power a tariff which would automatically reduce rates without such a hearing.[31]

(a) *The Public Utilities Code permits the use of annual adjustment clauses.*

(1a) Section 728 of the Public Utilities Code simply provides that the commission "after a hearing" may adjust improper "rates, classifications, rules, practices, or contracts";

31. The relevant sentence of Public Utilities Code section 728 reads as follows: "Whenever the commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices, or contracts affecting such rates or classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

on its face, then, nothing in the statute is inconsistent with the use of an annual adjustment clause.

The commission and the utilities, however, impliedly assert that the terms "rates" and "hearing" in section 728 have extremely restrictive meanings which bar adjustment clauses. Their position depends upon the conception that a "rate" is a single set of unvarying fixed charges, and that a "hearing" must occur before each variation in those charges. Neither contention withstands scrutiny.

In the first place, longstanding commission practice in other areas refutes its position in these cases. As testimony in the instant proceedings revealed, the commission has for a number of years included fuel adjustment clauses in the tariffs of power companies on the grounds that the variation in their fuel costs is disproportionate to the variation in their other costs.[32] Thus the commission itself has long recognized adjustment clauses do not exceed its authority.

(2) "Consistent administrative construction of a statute over many years, particularly when it originated with those charged with putting the statutory machinery into effect, is entitled to great weight and will not be overturned unless clearly erroneous. (*Federal Trade Com.* v. *Mandel Brothers* [1959] 359 U.S. 385, 391 . . .; *United States* v. *American Trucking Assns.* [1940] 310 U.S. 534, 549 . . .; *United States* v. *Leslie Salt Co.* [1956] 350 U.S. 383, 396 . . .; *Great Northern Ry. Co.* v. *United States* [1942] 315 U.S. 262, 275-276 . . .; *Norwegian Nitrogen Co.* v. *United States* [1933] 288 U.S. 294, 315 . . .; *Mazer* v. *Stein* [1954] 347 U.S. 201, 213 . . .; see 1 Davis, Administrative Law Treatise, § 5.06, p. 324.)" (*Di-Giorgio Fruit Corp.* v. *Dept. of Employment* (1961) 56 Cal.2d

32. *Re Southern California Edison Co. Ltd.* (1941) 43 C.R.C. 733; *Re Southern California Gas Co.* (1958) 56 Cal.P.U.C. 158; *Re California Electric Power Co.* (1958) 56 Cal.P.U.C. 221; see *Re Pacific Gas & Electric Company* AVTGVQ GV *Cal.P.U.C.* 724, 758-759; cf. *Riverside Cement Co.* v. *Public Util. Com.* (1950) 35 Cal.2d 328 [217 P.2d 403].

54, 61-62 [13 Cal.Rptr. 663, 362 P.2d 487].) **(1b)** Moreover, in the instant case no party presents any valid reason for holding this longstanding administrative interpretation unlawful.

In the face of this authority, the commission and the real parties in interest simply argue that the fuel adjustment clauses which it employs as a standard practice supply no precedent for the use of annual adjustment clauses for tax reserves. They urge that such clauses characteristically *raise* utilities' rates (as they have during the recent inflationary period) and therefore supply no authority for a clause which is expected to *reduce* rates.[33] In our opinion the objection is specious; the statutory language simply does not differentiate between the rate changes which increase rates and those which decrease rates.

Moreover, such consistent administrative practice accords with the conclusions of a sister court which, some 20 years ago, faced a question very similar to that which we now consider. In *Norfolk* v. *Virginia Electric etc. Co.* (1955) 197 Va. 505, 516-518 [90 S.E.2d 140], the Virginia Supreme Court addressed the contention that an annual adjustment clause could not be inserted in the tariff of a utility because the new rate would take effect without the 30-day notice to the public required by the relevant statute.

Rejecting this contention, the unanimous court wrote: "[T]he power of the Commission is not limited to the mere change of a particular rate that the public must pay for the service rendered by a public utility, but it has the power to change . . . any part of a filed schedule, rate, rule or regulation that in any manner affects the rates charged or to be charged. . . . '[R]ate schedules consist not merely of lists of rates in dollars and cents, but . . . they customarily include provisions that will in various ways affect the rates charged at the time of filing or to be charged thereafter.' [¶] The proposed escalator clause is nothing more or less than a fixed rule under which future rates to be charged the public are determined. It is simply an addition of a mathematical formula to the fixed schedules of the company. . . . [I]t is clear that notice is not required on each occasion there is a change in the ratepayers' bills, but that notice is required for every change in the filed schedules which are the underlying bases for the computation of those bills."

33. During proceedings before the commission, Pacific raised the additional objection that power company fuel adjustment clauses supplied no precedent for the use of a tax reserve clause because the commission derived its power to use fuel clauses from Public Utilities Code section 454, not section 728. Section 454, however, merely exempts rate increases established pursuant to adjustment clauses from the new requirement that certain classes of utilities enclose with their regular billings all notices of rate increase applications. Only *common carriers* are exempted *additionally* from the requirement of a hearing before rate increases (Pub. Util. Code, § 454, subd. (b)). Thus section 454 establishes no exemption from setcion 728 for fuel clause increases; if, therefore, hearings are required before all rate changes under section 728, they are also required for fuel clause changes. As we have shown, however, such hearings are not requisite when they have occurred as to the general tariff including such adjustment clauses.

Finally, in addition to longstanding administrative interpretation and the judicial authority described above, the purpose behind the hearing requirement of section 728 demonstrates the permissibility of the annual adjustment scheme here at issue. The purpose of the hearing is to air the policy considerations behind various rate proposals and to establish controverted facts; as the commission's experience with fuel clauses has shown, a hearing serves no purpose when the only business at hand is the application of a mathematical formula to a figure definitively established by reference to the utilities' books. The legislative purpose behind section 728 is better served by a plenary consideration of the advantages and disadvantages of an annual adjustment clause than by a yearly charade attendant to its application.

(b) *The Constitution does not forbid the use of annual adjustment clauses.*

(3a) As noted, the commission and the real parties in interest additionally argue that because a tariff containing an automatic adjustment clause could result in a decreased rate

which would take effect without a prior hearing attendant to a full rate proceeding, the resulting rate decrease would constitute a taking without due process, in violation of the Fourteenth Amendment of the United States Constitution. As we explain, however, this argument ignores the elaborate safeguards attending both the establishment of the accounting procedures which the utilities must use to produce the relevant figures and the full hearing which would accompany the establishment of the tariff containing the adjustment clause. As we shall show, under the governing authorities, these safeguards render the use of annual adjustment clauses entirely constitutional.

(4) Before discussing the specific objections to the adjustment clause, we review the constitutional standards which the United States Supreme Court has set forth for such rate proceedings. The court has long made it clear that within the regulatory context due process is a flexible concept, permitting expert administrative agencies broad latitude in adapting the specific regulatory needs of their jurisdictions.

(5) Thus, in sustaining the actions of a federal regulatory agency against the complaint of a utility that commission procedures in setting rates had deprived it of a hearing, the court set forth the relevant due process criteria: "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." (*Power Comm'n* v. *Pipeline Co.* (1942) 315 U.S. 575,

586 [86 L.Ed. 1037, 1049-1050, 62 S.Ct. 736]; accord, *R. R. Comm'n* v. *Pacific Gas Co.* (1938) 302 U.S. 388 [82 L.Ed. 319, 58 S.Ct. 334]; *West Ohio Gas Co.* v. *Public Utilities Com'n.* [No. 1] (1935) 294 U.S. 63, 70 [79 L.Ed. 761, 768-769, 55 S.Ct. 316]; *Market Street R. Co.* v. *Comm'n* (1945) 324 U.S. 548, 562 [89 L.Ed. 1171, 1182, 65 S.Ct. 770]; see *Norwegian Nitrogen Co.* v. *United States* (1933) 288 U.S. 294, 317, 319 [77 L.Ed. 796, 808, 809, 53 S.Ct. 350].)

(3b) With these precepts in mind, we consider the utilities' contention that the use of an annual adjustment formula exceeds constitutional bounds because it fails to provide the utilities with a prior hearing before each annual adjustment of rates occurs. As we explain, however, contrary to the utilities' assertions, procedural safeguards mark every stage of the adoption of the annual adjustment formula.

As we have already shown, the commission must hold a full hearing before the promulgation of a general rate tariff. (Pub. Util. Code § 728.) At such a hearing, the company has the opportunity through testimony, briefs, exhibits, and oral argument to inspect and challenge any formula proposed. (Pub. Util. Code, § 1705; Cal. Admin. Code, tit. 20, §§ 52, 59-61, 64, 68-70, 75-76.) The utility may at that hearing raise its objections either to the general concept of an adjustment clause or to the particular one proposed. It can point to states of fact on which the formula might yield an unjust or undesirable result and suggest corrective modifications. Indeed Pacific, at whose hearing annual adjustment was most fully developed, in fact took advantage of most of the procedural rights just enumerated. Under the circumstances, the promulgation of an annual adjustment formula as part of a general utility tariff obviously comports with due process; it remains therefore only to consider if the periodic application of the formula to the figures in the utility's books entails any denial of due process.

The adjustment clause would operate upon figures which the utilities had placed in their account books in accordance

with the system of accounts as to which the companies had received another, prior hearing. (Pub. Util. Code, §§ 792, 794.)[34] The utility, of course, would have made the entries with the full knowledge that the commission would employ them in connection with the annual adjustment clause.[35] Having thus obtained the appropriate figures from the utilities' accounts (cf. Pub. Util. Code, § 791), the commission would proceed to apply them to the formula as to which the utility would have enjoyed ample opportunity to make its objections known at a full hearing. (Pub. Util. Code, § 728; Cal. Admin. Code, tit. 20, §§ 51-88.) The insertion of numbers derived[36] from an accounting system adopted at one hearing, into a formula approved at another hearing does not deny due process; the Fourteenth Amendment to the United States Constitution does not prohibit arithmetic.

Our holding accords with the authorities. Most closely in point is the decision of the Virginia Supreme Court, which faced, in addition to the statutory issues discussed above, a

34. Empowered by law to "establish a system of accounts to be kept by the public utilities subject to its jurisdiction" (Pub. Util. Code, § 792), the commission has, when appropriate, held hearings on the establishment of such uniform accounts. (See *In re Uniform System of Accounts* (1948) 48 Cal.P.U.C. 253; *First Supplemental Order* (1957) 55 Cal.P.U.C. 668; cf. Pub. Util. Code, § 793; 64 Cal.P.U.C. 27; 70 Cal. P.U.C. 470.) Having established such accounting systems, the commission may prescribe the manner in which the regulated utilities employ them, but only after granting the utilities an opportunity to be heard on this question. Public Utilities Code section 794 provides that: "[t]he commission may, *after notice, and hearing* if requested within 15 days after receipt of notice, prescribe by order the accounts in which particular outlays and receipts shall be entered, charged or credited." (Italics added.) The commission's decision after such a hearing is of course subject both to rehearing and to judicial review. (Pub. Util. Code, §§ 1731, 1756.)

35. Such figures might include both already incurred tax expenses and the utilities' own estimates of future tax expenses. The staff member testifying most extensively as to the annual adjustment method idicated that it might be desirable to confirm the figures for tax expenses with those reported to the utility's stockholders under the reports required by the federal Securities and Exchange Commission.

36. As in the case of fuel clauses, the commission may find it necessary to make minor adjustments in the raw figures derived from the utilities' books before applying them to the annual adjustment clause. In light of the protections attending the development and use of the clause, we perceive no constitutional significance to flow from this practice.

claim by ratepayers that a fuel adjustment clause would deprive them of due process because it did not afford them notice and hearing as to each of its applications; the court rejected the claim.[37] (*Norfolk* v. *Virginia Electric, etc. Co., supra,* 197 Va. 505.)

In so holding, the Virginia court spoke to the issue before us; after pointing to the widespread adoption of such clauses and their survival of legal challenges, it succinctly refuted the claim that their application constituted a denial of due process: "The City next contends that the escalator clause results in a denial of procedural due process of law to the consumers because there is no public notice and hearing on each occasion when the actual rate is increased. . . . In the instant case there was sufficient notice to the public that the Commission would hold a formal hearing on the application of the Company to determine whether it was just and reasonable to insert the escalator clause into its filed schedules. The City appeared and participated in the proceedings and after an investigation by the Commission and a full hearing, the Commission found as a fact that the proposed escalator clause was 'just and reasonable', a finding which the record does not warrant us in reversing. Consequently, the requirements of procedural due process have been fulfilled in this case. See, e.g., Railroad Commission of State of California v. acific Gas & Elec. Co. [1938] 302 U.S. 388 . . .; Ohio Bell Telephone Co. v. Public Utilities Comm. [1937] 301 U.S. 292 . . ." (*Norfolk* v. *Virginia Electric, etc. Co., supra,* 197 Va. 505, 516-518.)

Norfolk thus stands for the proposition that due process requires adequate hearings at the significant point of the adoption of the adjustment clause, rather than at the relatively unimportant occasions of its application. Measured by this

37. The court in considering the ratepayers' claims assumed that they stood entitled to due process in connection with any increase in their rates; the utilities in the instant cases can therefore derive little comfort from the circumstance that the customer rather than the utility raised the due process claim.

standard, the system of annual adjustments proposed by the hearing examiner and the commission staff would offend no tenet of due process.

This conclusion finds additional support in cases which have addressed the question whether due process requires that agencies afford regulated entities a hearing before acting on the basis of figures or data supplied to the agency by the utility itself. The question is relevant to the instant case, because the annual adjustment clause would operate upon figures entered by the utilities upon its own books. The utilities claim that due process entitles them to a hearing prior to the use of such figures; the authorities do not support this contention.

In a leading case a unanimous United States Supreme Court rejected the contentions of a California utility that the commission had denied it due process by using, at its rate base, the figure for which the utility had offered to sell itself to the city in which it was located. (*Market Street R. Co.* v. *Comm'n.*, *supra*, 324 U.S. 548.) The railway argued that the use of this figure, which had found its way into evidence incidentally, and which the commission had not indicated it would use to fix the utility's value, denied it due process absent an opportunity to present argument concerning the accuracy and interpretation of the figure. The Supreme Court found the argument without merit; Justice Jackson, writing for the court, noted that the figure in question had been admitted into evidence without limitation as to use: "Doubtless the decision and the grounds of decision were unexpected. But surprise is not necessarily want of due process." (*Id.*, at p. 558 [89 L.Ed. at p. 1180].)

Nothing in the operation of the annual adjustment clause as here proposed even approaches the procedure which generated the utility's complaint in *Market Street Railway;* unlike the railway, the telephone companies would at all times know the use to which the commission intended to put the tax re-

serve figures and would have an ample opportunity to make known their views of such proposed use.[38] (See *American Toll Bridge Co.* v. *Railroad Com.* (1938) 12 Cal.2d 184, 203-204 [83 P.2d 1].)

As further demonstration of the annual adjustment clause's impregnability to constitutional attack, we briefly contrast its operation with regulatory procedures which have *failed* to survive judicial scrutiny under the due process clause. The utilities insist that these cases pose an insuperable constitutional barrier to the use of an annual adjustment clause; we shall show, however, that they are in fact entirely distinguishable. In *Ohio Bell Tel. Co.* v. *Comm'n.*, *supra* 301 U.S. 292, the commission had, without informing the utility of its intention to do so, taken judicial notice of a general decline in the prices of property and then adjusted downward the values of particular utility properties, all without telling the utility of the method by which it arrived at its figures or permitting it to challenge them; the court held this procedure unconstitutional.

Without belaboring the obvious differences between the unconstitutional procedure in *Ohio Bell* and that proposed in the case of annual adjustment, we simply note that in the latter instance the operative asumptions of the commission would at all times be known to the parties. (Accord, *Moore-McCormack Lines, Inc.* v. *United States* (1969) 413 F.2d 568, 585 [188 Ct. Cl. 644].)

In striking down the procedure in *Ohio Bell* the court made reference to an earlier case upon which the utilities before us

38. In a case similar to *Market Street Railway*, an Emergency Court of Appeals rejected a claim by a manufacturer subject to the authority of the Office of Price Administration. The administrator, in fixing the price on regular building blocks sold by the manufacturer, had calculated the manufacturer's cost by subtracting from a figure previously supplied by the plaintiff for blocks with special features the sum claimed to be attributable to such special features. (*Schiefla* v. *Clark* (E.C.A. 1974) 163 F.2d 685.) The court held that the use of the plaintiff's own figures did not constitute a denial of due process even though the manufacturer had received no prior notice of the purpose for which the administrator might use the figures.

rely; *West Ohio Gas Co.* v. *Comm'n.* [No. 2], 294 U.S. 79 [79 L.Ed. 773, 55 S.Ct. 324], epitomized the defects also found in *Ohio Bell.* In *West Ohio* the regulatory agency had, in setting a rate in 1933, chosen to rely exclusively on data from 1929, ignoring available revenue and expense data from 1930 and 1931; the court held this procedure unconstitutional.

In examining the flaws in *West Ohio* one is struck by the contrast they present to the proposed annual adjustment clause in question, in spite of the utilities' assertion to the contrary. The defect in the *West Ohio* case lay in the commission's refusal to consider the latest available data as to costs and revenue; yet annual adjustment entails precisely the substitution of actual figures for guesses and estimates of tax expense and deferred reserves. Rather than taking a single year as the measure of tax reserves, the commission staff proposed to make period adjustments in the figures in the light of actual experience, prcisely the course approved by the court in *West Ohio.* The utilities, of course, complain that the commission would make such adjustments only in the tax deferral figures, and not in the other revenues and expenses of the company; but, as we have already shown, the distinctive treatment of tax expenses and reserves finds its warrant in the circumstance that under accelerated depreciation they will vary abnormally with respect to the other components of the utilities' finances. Simply to recognize this fact is not to deny due process.

Nor does due process require a hearing that serves no useful purpose. In the instant case the only relevant inquiry turns upon the figures that stand in specified places in the utilities' books. No facts are open to serious dispute, no witnesses' demeanor need be judged, no policy decisions on which public sentiment might prove useful are before the commission. Within such a context, the facts are those which Professor Davis terms "legislative," and as to which a hearing serves no function.[39] (1 Davis, Administrative Law Treatise (1958) pp. 429-437 (1970 Supp.) pp. 327-329; *Rivera* v. *Division of Industrial Welfare* (1968) 265 Cal.App.2d 576 [71 Cal.Rptr. 739].)

The crux of the utilities' objections to annual adjustment lies in the possibility that under certain circumstances the annual adjustment clause might yield a rate below their authorized return, or in extreme situations, they assert, on the border of confiscation. The crucial point which they fail to discern, however, is that *any rate may have such an effect, no matter how calculated.*

An entirely fixed and stable rate may, if expenses rose dramatically, yield insufficient revenues to guarantee the utility a reasonable return. Yet we have never viewed this possibility as a ground for constitutionally requiring expense escalation clauses; the appropriate remedy in such instances is an application for a rate increase (Pub. Util. Code, §§ 454, 455). Conversely, the fact that a tariff containing an annual adjustment clause keyed to the growth of a deferred tax reserve may, under imaginatively conceived circumstances, rduce the rate of return below that authorized does not render it unconstitutional.

The utilities' objections are therefore inapposite. The due process cases they cite are, as we have shown, concerned with procedural defects not here present. Nothing in the procedures suggested to the commission will deny the utilities full hearings both on the system of accounts which will yield the figures in question and on the formula to which the figures will be applied.

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39. Nothing we say, of course, would preclude the commission from permitting the utilities to submit written briefs at the time of the annual adjustment, if the commission thinks such a procedure useful. Under the circumstances, however, this practice is not constitutionally mandated. (Cf. 1 Davis, Administrative Law Treatise (1970 Supp.) p.332; *Dyke Water Co.* v. *Public Utilities Com.* (1961) 56 Cal.2d 105 [14 Cal. Rptr. 310, 363 P.2d 326], cert. den., 368 U.S. 939 [7 L.Ed.2d 338, 82 S.Ct. 380].)

(c) *The commission therefore erred in failing to consider annual adjustment.*

Because annual adjustment comports both with the governing statutes and the Constitution, the commission failed regularly to pursue its authority in failing to consider it.[40] (Pub. Util. Code, § 1757.) On remand the commission should proceed either to take further testimony on the system, or to consider its adoption on the basis of the testimony contained in the record of the instant cases.[41] It should in any case weigh its desirability and set forth the reasons for the decision it ultimately reaches.[42] (Pub. Util. Code, § 1705.)

3. *The commission did not otherwise err.*

In the decisions before us the commission ruled as to a number of points other than those already discussed; the petitioning cities complain of several of these rulings. We have carefully examined both the petitioners' contentions and the record before the commission and find no error calling for annulment other than that indicated above.[43] (Pub. Util. Code, § 1757.) We dwell further on only one point which, because it relates to commission procedure, may recur.

(6) The petitioning Cities of Los Angeles and Long Beach (in S.F. 23237) complain that the commission erred in failing to abrogate General's entire staff after we annulled Pacific's tariff in *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119. In order to show that the commission did not err, we briefly set forth the relevant chronology.

When we disapproved the commission's order in *City and County of San Francisco,* the commission had just filed a decision incorporating a rate increase for General Telephone, based in part on the same treatment of federal tax expenses which we held erroneous in the *Pacific* case. (*Re General Telephone Co. of Cal.,* 72 Cal.P.U.C. 652.) Upon learning of our decision in *City and County of San Francisco* the cities which had appeared before the commission in the proceeding leading to the

40. In its opinion on denial of rehearing in the Pacific case the commission set forth an alternative proposal which entailed its reception of periodic reports of the utilities' profits with an eye towards reopening proceedings should they exceed the authorized rate. (*Re Pacific Telephone and Telegraph Co.* 1974)—Cal.P.U.C.—(Decision No. 83540).) The commission subsequently adopted the same procedure for General. (*Re General Telephone Company* (1974)—Cal.P.U.C.—(Decision No. 83779, slip opn., pp. 29-31.)) While such continuing supervision appears to be in commendable accord with the commission's statutory duties (Pub. Util. Code, §§ 451, 701, 728), it fails to serve as an adequate substitute for the consideration of annual adjustment on two grounds. First, the holding out of the possibility of future action does not constitute a justification for failure to take present action. Second, the commission's procedure verges dangerously on shifting the burden for justification of rate increases from the utility, where Public Utilities Code section 454 places it, to the ratepayer. The commission's order on denial of rehearing therefore does not alter the outcome of the instant case.

41. Pacific, of course, has had a full hearing on the use of annual adjustment, and as to it the commission enjoys the election described. In the General proceedings, the commission, although under a duty to do so, did not consider annual adjustment, and General consequently stands entitled to a hearing before incorporation of the system into its rates.

42. In this connection we emphasize that nothing in the course of this opinion should be construed as binding the Public Utilities Commission either now or in the future to any *particular* method of rate-setting which it decides is not useful. For instance, because the size of the utility's reinvestment is affected by the rate of inflation in the entire economy, under certain severe conditions of deflation even a utility expanding its plant investment would not incur sufficient expense (because the replacements would cost substantially less than the old assets) to offset the lower depreciation attributable to "old" assets in their later years. Under *such* conditions a public regulatory commission might well adjust its rate-setting assmuptions. (Cf. *Power Comm'n* v. *Hope Gas Co.,* 320 U.S. 591 [88 L.Ed. 333, 64 S.Ct. 281]; *Bluefield Co.* v. *Public Serv. Com.* (1923) 262 U.S. 679, 692-693 [67 L.Ed. 1176, 43 S.Ct. 675].) Thus, should conditions change, or should the commission in the *considered* exercise of its discretion (Pub. Util. Code, § 1705) conclude that a method which we hold it empowered to employ is not suitable, it may reject the method.

Conversely, should the commission on remand decide that a method which it has previously rejected on prudential grounds now appears feasible, it may adopt the method. Thus, if, upon reconsideration, the commission should conclude to implement pro forma normalization on a tentative basis, with rates held in a trust fund, subject to refund upon final determination of federal tax questions, nothing we say here should be construed to forbid such a course of action. Alternatively, the commission could choose to mitigate the "windfall" accruing to real parties in interest in consequence of their failure to elect accelerated depreciation prior to 1969, by setting more modest rates of return in recognition of the additional source of capital available to the utilities by virtue of the federal tax laws.

We rule only on the *availability* of a method of remedying a serious problem perceived by the commission, a method whose usefulness the commission tacitly conceded, but which it declined to consider, solely because it believed itself powerless to implement.

43. As noted above, we do not in so holding endorse or pass upon the legal merits of the commission's interpretation of the 1969 amendments to the Internal Revnue Code and the regulations interpreting them.

General decision, petitioned for a *rehearing* which the commission granted. (Decisions Nos. 79532 and 79367.) We subsequently annulled the entire rate based on the tax decision held erroneous in *Ciay and County of San Francisco. (City of Los Angeles* v. *Public Utilities Commission, supra,* 7 Cal.3d 331.)

In granting rehearing the commission limited the issues to the question of tax expenses and promulgated the previous tariff as an *interim* rate subject to refund if the commission subsequently found it erroneous. After this rehearing (at which the commission did not consider annual adjustment), it effectively reaffirmed the interim rates as part of the permanent tariff.

From the previous discussion, it is clear that as a substantive matter the commission erred in failing to consider annual adjustment.[44] The petitioning cities also complain, however, that the commission erred in repromulgating the tariff under attack as an *interim* rate; by analogy to our action in *City of Los Angeles* they argue that the commission bore the duty to annul the *entire* rate. Because the rates suffered from the same failure to consider alternatives, they argue, both rates must have been annulled. In this analogy between our decision and the commission action, however, lurks a fatal flaw.

The key to the distinction between the two cases lies in the difference in the commission's power, on one hand, to *reopen* proceedings already final, and, on the other, to *rehear* a decision not yet final. In *City of Los Angeles* we annulled the tariff in question, in spite of the fact that the commission had *reopened* rate proceedings under Public Utilities Code section

44. Because the commission took the steps just outlined, we were not called upon to annul General's rate as we had that of Pacific in *City and County of San Francisco.* The governing law, however, was clear from that case, and the commission bore a corresponding similar duty to consider alternative methods of dealing with General's accumulating tax reserves. Annual adjustment was before it in the parallel proceedings after annulment in the Pacific case, which was filed before the decision on rehearing in the General case.

1708. That section, which we set forth in the margin,[45] permits the commission at any time to reopen proceedings even after a decision has become *final,* as the commission decision in *City of Los Angeles* would have been had we not annulled. (*City of Los Angeles* v. *Public Utilities Commission, supra,* 7 Cal.3d 331.)

In that case we explicitly based our annulment on the decision's finality: "It follows that, unless the rate order now before us is annulled, it will *become a lawful rate* and that all funds collected pursuant to it would belong to Pacific and not be subject to refund. [¶] In other words, we must annul the rate order now before us, because otherwise the rates therein, which are based in part on the annulled tax expense decision, will *become lawful rates* for the future and will preclude refunds." (*Id.*, p. 338; italics added.)

In the General case, on the other hand, the time for *rehearing* had not expired and the rate had not become final and lawful. The difference in effect stems from the difference between Public Utilities Code section 1736,[46] which provides for an order on *rehearing,* and section 1708 which provides for *reopening.* The former procedure, which must take place within the time limits specified in section 1731, and only in response to parties' requests, contrasts with the latter, which is merely a general authority for the commission to reconsider some-

45. "The commission may at any time, upon notice to the . . . parties, and with opportunity to be heard as provided in the case of complaints, rescind, alter, or amend any order or decision made by it. Any order rescinding, altering, or amending a prior order or rdecision shall, when served upon the . . . parties, have the same effect as an original order or decision." (Pub. Util. Code, § 1708.)

46. Section 1736 reads in its entirety as follows: "If, after such rehearing and a consideration of all the facts, including those arising since the making of the order or decision, the commission is of the opinion that the original order or decision or any part thereof is in any respect unjust or unwarranted, or should be changed, the commission may abogate, change, or modify it. The order or decision abrogating, changing, or modifying the original order or decision shall have the same force and effect as an original order or decision, but shall not affect any right or the enforcement of any right arising from or by virtue of the original order or decision unless so ordered by the commission."

thing upon which it has previously ruled. Rehearing, unlike reopening, prevents an order previously made from becoming final. (See *Sale* v. *Railroad Commission* (1940) 15 Cal.2d 612, 616 [104 P.2d 38].) Because the commission *reheard* the General case, its order did not become final, and it could promulgate an interim rate subject to refu .. The commission's procedure in Decision 83778 was therefore lawful although its substantive result must be annulled for failure to consider annual adjustment.

4. *Order.*

Because the commission has failed regularly to pursue its authority, the rates here under review may not stand in their entirety. (Pub. Util. Code, § 1757.) Yet, because we have found error only in respect to the treatment of tax expenses, we need to annul only the portion of the rate based on such error. Unlike the situation facing us in *City of Los Angeles* v. *Public Utilities Commission, supra,* 7. Cal.3d 331, in which we noted that "[n]o basis appears to sever these matters from the increase of rates ordered by the commission, and it is not claimed that severance is possible" (*id.* at pp. 353-354), the commission in the instant case has gone to some lengths to "set out the dollar effect of the adjustment so that if . . . [it is] found wrong . . . the correct adjustment can readily be made." (*Re Pacific Telephone and Telegraph* (1974)—Cal. P.U.C.—(Decision No. 83162, slip opn. p. 64).)

Not only such passages but also the commission's actions in these cases demonstrate the severability of the tax related aspects of the rates before us. Thus upon rehearing in the General case, the commission discovered that California taxes, unlike their federal counterparts, were amenable to flow-through treatment and ordered appropriate refunds, thereby demonstrating the practicability of partial annulment. (*Re General Telephone of California* (1974)—Cal.P.U.C.—(Decision No. 83778, slip opn. pp. 48-49).)

In order, therefore, not to interfere with those portions of the tariff in which we find no reversible error, we affirm the commission's order except insofar as it depends upon the erroneous treatment of tax expenses set forth above; as to that portion of the rate we annul. The commission, on remand of this matter for further proceedings consistent with this opinion, shall expeditiously determine what position is will adopt with respect to the tax expense issue. (See *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 130-131.) Having ascertained this position, be it annual adjustment or some other alternative, including the possibility of a commensurate adjustment in the rate of return, the commission shall provide for refunds, if appropriate, to the ratepayers of the difference between such a rate and the tariff reviewed herein.

Wright, C. J., McComb, J., Mosk, J., Clark, J., Richardson, J., and Taylor, J.,* concurred.

APPENDIX B

ANSWER OF CITY OF LOS ANGELES ET AL IN S.F. NO. 23743 AND S.F. NO. 23746 PP. 2-13

I.

PRELIMINARY STATEMENT

The Petitions of General and Pacific ask this Court to review the intrastate ratemaking treatment of accelerated depreciation and investment tax credit once again. This issue has been before the Commission and the California Supreme Court since 1970. On three separate occasions the California Supreme Court has unanimously annulled the Commission ratemaking treatment of these taxes.[1] In these cases, the Cities individually or in concert were petitioners seeking to overturn the Commission's adoption of the telephone companies' normalization method of ratemaking. The Cities have at all times asserted that a flow-through method of ratemaking is required.[2] This Court, in the three aforementioned unanimous decisions, rejected the Commission normalization orders and indicated that some compromise or alternative method would be a satisfactory solution for ratemaking purposes.

The present case arises out of a slightly different set of circumstances. The Commission for the first time has adopted a compromise between the telephone companies' normalization method and flow-through. Pacific and General challenge the Commission order and persist in their efforts to compel the commission to adopt the telephone companies' interpretation of normalization ratemaking as a matter of law.

---

1. *City and County of San Francisco* v. *Public Utilities Commission,* (1971) 6 Cal.3d 119; *City of Los Angeles* v. *Public Utilities Commission,* (1972) 7 Cal.3d 331; *ity of Los Angeles* v. *Public Utilities Commission,* (1975) 15 Cal.3d 680.

2. The flow-through and normalization methods are described in detail in *City and County of San Francisco* v. *Public Utilities Commission (supra)* and *City of Los Angeles* v. *Public Utilities Commission,* (1975) 15 Cal. 3d 680.

The Cities believe that flow-through is the appropriate ratemaking treatment. Moreover, we believe the alternative adopted by the Commission in Decision No. 87838, although a compromise, fails to account for the imprudence of the telephone companies and therefore is not in the best interest of the ratepayers. Notwithstanding the disagreement with the Commission order, the Cities are not challenging Decision 87838. In this Answer we defend the Commission's decision as a good faith compromise consistent with the prior decisions of this Court.

The following reasons indicate the basis for our decision not to appeal:

1. The Con.mission did in fact adopt a compromise ratemaking method.
2. Although the position adopted by the Commission culminates in a significant windfall and financial advantage to the telephone companies, nevertheless the Cities believe that it was a good faith compromise consistent with the Court's directive to seek a reasonable alternative.
3. The Cities continue to believe that flow-through is the best ratemaking treatment or, in the alternative, that a better compromise can be achieved. However, we feel that in succeeding rate cases the Commission will have the opportunity to revise the ratemaking treatment ordered in Decision 87838 and at that time adopt the method advanced by the cities. The Court had made it clear that the commission is not and should not be bound to any *particular* method of ratemaking.[3] The Cities are encouraged by the Commission's recognition in Decision 88215 that flow-through may well be the proper methodology and subsequently could be adopted:

   "We should also point out that if Pacific's and General's request result in a loss of eligibility it will be necessary for the Commission to consider setting the rates of Pacific and General on a flow-through basis." (*Pacific Telephone*, —— CPUC ——, Decision 88215, December 6, 1977 at p. 3 attached as Appendix A to this answer.)
4. We are in accord with Pacific's statement that "[t]his matter should be brought to a conclusion." (Petition, S.F. No. 23746 at Page 72.) Rates have been collected, subject to refund, since 1971 and the Cities believe that the refunds and reductions ordered by the Commission should be made forthwith. The Commission's good faith compromise, although inadequate by our standards, should be accepted and further revisions in rates can be made in subsequent cases.

3. *City of Los Angeles* v. *Public Utilities Commission*, (1975) 15 Cal.3d 680 at 704, Footnote 42.

The aforementioned reasons formed the basis for the Cities decision not to appeal the Commission's tax ratemaking treatment notwithstanding our belief that it is unfair to the consumers.

The remainder of this Answer will address the reasons for which this Court should deny the Petitions for Writ of Review. The subsequent sections will only answer the specific contentions raised in the Pacific Petition since for the most part the General petition is repetitious. However, in the area of managerial imprudence this answer will directly address the General Petition.

II

PACIFIC TELEPHONE HAS IMPROPERLY FRAMED THE RELEVANT ISSUES.

At the very outset of its points and authorities, on Page 11, Pacific declares in bold type that "[t]he federal tax questions are the central issues in this case." Moreover, the petition

closes with the statement that "[t]he intent of Congress and reqirements of Federal law should be observed and the decision should be annulled." (Pacific's Petition, S.F. No. 23746, at Page 72.) We disagree that these are the primary issues. Decision 87838 is unequivocally an intrastate ratemaking case. This is not a federal tax law case. The sole issue involved is whether or not the Commission adopted a ratemaking alternative consistent with the remand instructions of this Court. Decision 87838 must be analyzed from this perspective. It is our position that based upon specific holdings of this Court in prior cases (see Footnote 1, Page 2 of this Answer), that federal tax eligibility does not control ratemaking of the Commission. Therefore, Decision 87838 must be upheld irrespective of the federal tax law consequences.

III

THE PUBLIC UTILITIES COMMISSION IN DECISION 87838 ADOPTED A COMPROMISE RATEMAKING TREATMENT CONSISTENT WITH THE COURT'S REMAND INSTRUCTIONS AND CONSISTENT WITH RATEMAKING CRITERIA.

In the *City and County of San Francisco* v. *Public Utilities Commission,* (1971) 6 Cal.3d 119, and again in the *City of Los Angeles* v. *Public Utilities Commission,* (1975) 15 Cal.3d 680, this Court urged the Commission "to consider lawful alternatives in the calculation of federal income tax expense and to strike a compromise between the normalization method supported by the telephone companies and the flow-through method urged by the Cities." (*City of Los Angeles* v. *Public Utlities Commission, supra,* at Page 689.) This Court made it clear that flow-through was a lawful alternative despite the possible loss of tax eligibility and that the adoption of flow-through by the Commission would not deprive Pacific of due process. (*City and County of San Francisco, supra,* at Pages 127-131.) This Court's recognition that a method more favor-

able to Pacific would be equally acceptable is evident in the following quote:

> "Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections." *City and County of San Francisco,* supra, at Page 131.

The Commission, in Decision 87838, adopted an alternative method of ratemaking as directed by this court. However, the Commission first found flow-through the best and most reasonable ratemaking treatment (Findings 1 and 2, Decision 87838 at Page 47.) Then it adopted normalization after safeguards were incorporated into the calculations to preclude Pacific and General from experiencing windfall profits. (Findings 3 and 4, Decision 87838 at Page 48.) The Commission recognized that the growth in the normalization reserve for both accelerated depreciation and investment tax credit was abnormal. (Finding 5, Decision 87838 at Page 49.) Failure to recognize such growth yields excessive rates above and beyond those consistent with normalization and rateable flow-through. For this reason the Commission took the following two steps:

1. With regard to accelerated depreciation it adopted the average annual adjustment method. Under this theory the Commission looks to the future taxes and the future growth in the normalization reserve.
2. With regard to the investment tax credit the Commission adopted the annual adjustment method discussed at length by the court in the Los Angeles Case (*City of Los Angeles, supra,*.)

These ratemaking methods achieve normalization accounting and concomittantly prevent windfall profits to the telephone companies. These methods also produce a slightly lower revenue requirement than the telephone companies' normalization method which was previously adopted by the Commission.

Consequently, the result is only a minor compromise between flow-through and normalization. This becomes evident once the impact upon the prospective reductions is contrasted with the amount of refunds which would result from the adoption of the full flow-method. If the Commission followed the recommendation of the Cities, a $261,000,000 rate reduction would have been required. (See calculation, Appendix B.) If the Commission had adopted the telephone companies normalization mthod, a rate reduction would not have been required. With the compromise ordered by the Commission, the total rate reductions mandated for Pacific was only $60,494,000. (Decision 87838 at Page 32.) This comparison clearly demonstrates the nature of the Commission order and cogently illustrates that the interest of the ratepayers suffered.

Assuming *arguendo* that normalization and rateable flow-through are reasonable means of ratemaking (an assumption with which the Cities totally disagree), then the average annual adjustment method and the annual adjustment method are necessary components of ratemaking. Rates would also be set on a test period basis. Moreover, the goal is not to determine actual expenses for that test period but to predict as reasonably as possible what will take place in the near future. The process is well described by the court in the following statement:

> "The test period is chosen with the objective that it present nearly as possible the operating conditions of the utility which are known or are expected to obtain during the future months or years for which the Commission purposes to fix rates. The test periods results are adjusted to allow for the effect of various known or reasonably anticipated changes in gross revenues, expenses, or other conditions, which did not obtain throughout the test period but which are reasonably expected to prevail during the future period for which rates are to be fixed, so that the test period results of operations as determined by the Commission will be as nearly represented of the future conditions as possible." (*Pacifc Telephone* v. *The Public Utilities Commission,* (1965) 62 Cal.2d 634 at 645.)

The extraordinary growth in both the normalization reserve and the investment tax credit, respectively, compelled the Commission to adopt its ratemaking methods for income tax treatment.

The methods (Average Annual Adjustment and Annual Adjustment) are consistent with the Commission's ratemaking treatment in other cases. With respect to state income taxes, the Commission adopted a projected three year average flow-through for accelerated depreciation as a result of the extraordinary growth in tax savings. (*Pacific Telephone,* —— CPUC ——, Decision Number 83162, July 23, 1974, at Page 74.) Moreover, this ratemaking method has gone uncontested by Pacific. In a Southern California Gas case, the Commission recognized the test year investment credit was extraordinarily high because of a gas storage project. Investment tax credit was therefore calculated on a five year average for the years 1971 through 1975 instead of merely adopting the 1972 test year figure. (*Southern California Cas Company* (1972) 74 CPUC 30, 49.) The aforementioned examples clearly illustrate that the Commission has adopted a ratemaking treatment consistent with the Court's directions and consistent with its own past regulatory treatment of similar issues.

IV

THE COMMISSION'S ORDER SHOULD BE SUSTAINED WITHOUT REGARD TO INCOME TAX ELIGIBILITY.

In succeeding sections we will demonstrate that the Commission's order will not cause Pacific or General to lose eligibility for tax savings available with accelerated depreciation and investment tax credit. The normalization method in addition will provide Pacific a massive windfall at the expense of the ratepayers in the form of reimbursement for nonexistent

taxes. Assuming *arguendo*, that Pacific and General will lose eligibility as a result of their efforts to gain a negative ruling from the Internal Revenue Service, this does not provide justification for overturning the Commission's order.

The court in the *San Francisco* case *(supra)* made it clear that flow-through was a reasonable ratemaking treatment in light of the imprudence of Pacific and General despite the possibility that the telephone companies could no longer use accelerated depreciation. (*City and County of San Francisco, supra*, at Page 129.) Hence, as a matter of law, this Court held that full flow-through is a viable legal alternative. This Court went on to state that a less harsh alternative would therefore be equally free from due process objection. (*City and County of San Francisco, supra*, at Page 130.) The ratemaking method adopted by the Commission will provide Pacific with over $200,000,000 more a year in revenues than imputed flow-through. Even with a loss of eligibility, this windfall is to the advantage of Pacific vis-a-vis flow-through. Neither state nor federal law prohibits the Commission from adopting such a ratemaking method and the Petitioners have failed to present any authority to the contrary.

The Commission provided this generous ratemaking alternative based upon its belief that such an alternative would preserve eligibility. If the Commission was wrong, income tax ineligibility would only provide a basis to revert back to flow-through. The Commission found the telephone companies to be imprudent and that flow-through was the proper ratemaking treatment. (Findings 1 and 2, Decision 87838, at Page 47.) In Decision Number 88215, the Commission expressly recognized that if Pacific loses eligibility, it would be necessary to consider setting rates on a flow-through basis. (See Decision 88215, Appendix A at Page 3.) If the Commission did make any legal error with regard to tax liability, this error resulted only in a massive windfall for the telephone companies and it not a basis for overturning Decision 87838.

June 22, 1978

Honorable Rose E. Bird, Chief Justice
Honorable Mathew O. Tobriner, Associate Justice
Honorable Stanley Mosk, Associate Justice
Honorable William P. Clark, Jr., Associate Justice
Honorable Frank K. Richardson, Associate Justice
Honorable Wiley W. Manuel, Associate Justice
Honorable Frank C. Newman, Associate Justice

The Supreme Court of the State of California
State Building
350 McAllister Street
San Francisco, CA 94102

Re. S.F. No. 23746 (The Pacific Telephone & Telegraph Company v. Public Utilities Commission of the State of California) and S.F. No. 23745 (Toward Utility Rate Normalization v. Public Utilities Commission of the State of California)

Dear Chief Justice and Associate Justices:

The Commission has been served with a copy of a letter to the Court in this proceeding signed by counsel for petitioner, The Pacific Telephone Company (Pacific), and dated June 9, 1978. By this letter Pacific forwarded a copy of a recent letter from an employee of the Internal Revenue Service (I.R.S.) responding to a request by Pacific for a ruling supporting Pacific's position before this Court in this proceeding.

Ordinarily the Commission would not feel compelled to respond to such a letter; the Commission, of course, has no objection to Pacific's providing the Court with the I.R.S. letter. However, in this instance, Pacific was unable to resist the temptation to use this subsequent event as an opportunity to reargue its case. Moreover, in doing so, Pacific has misquoted the Commission, misstated the prime issue of these proceedings and persisted in a position as to the effect of an I.R.S. letter

on its eligibility for use of accelerated depreciation which is clearly contrary to law. Such contentions cannot go unanswered.

First, on page one of its letter, Pacific uses a phrase, ". . . horrendous consequences," places it in quotation marks and refers to certain pages of Decision No. 87838. The obvious conclusion is that Pacific is quoting the decision. However, this is incorrect; that phrase is not contained anywhere in the decision. The decision uses the word "horrendous" only once and that on page 10 where it states, after discussing the probable consequence of imputing flow-through for ratemaking purposes, "[t]his horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator."

Pacific's attempt to mislead the Court by misquoting the Commission's decision should be rejected.

Second, Pacific misstates the issue of these proceedings, as being " . . . whether the ratemaking methods adopted by the California Public Utilities Commission in Decision No. 87838 are consistent with the eligibility requirements of Federal law. . . ." Both Pacific and Toward Utility Rate Normalization (T.U.R.N.) posed many more issues than that in their petitions. Moreover, as the Commission pointed out in its answer, the prime issue is actually that of the lawfulness of the Commission's decision as an exercise of its mandated authority under the California Constitution and the Public Utilities Code.

Finally, and most importantly, Pacific would have this Court believe that, as a consequence of the I.R.S. letter, it has lost its eligibility to use accelerated depreciation. This is simply wrong. The opinion stated in the letter is made on the staff level and is not even binding on the I.R.S. It is not an assessment of tax liability. If this Court affirms Decision No. 87838 and the I.R.S. makes an assessment of tax liability adverse to

Pacific, such an assessment is appealable, administratively within the I.R.S., as well as through the U.S. Tax Court or the Federal District Court. This is a long road upon which Pacific may not have to travel but which the law very clearly has made available to any taxpayer.

Pacific chooses to pretend that such opportunities do not exist because such a posture suits its tactics before this Court and its use of its pleadings in these proceedings as news releases to the media. However, that pretense should not be allowed to obscure the fact that Pacific's eligibility or loss thereof will not be decided in the daily press nor by a letter from a staff member of the I.R.S. but, eventually, by the Court.

As to the I.R.S. letter itself, the Commission observes that the author thereof provides no basis for his conclusion that the AAA method is inconsistent with sections 1.167(l)-1(h)(1)(i), (iii) and 1.167 (l)-1(h) (2)(i) of the regulations and, furthermore, appears totally oblivious to the body of law which has explained that the use of accelearted depreciation along with the normalization of accounting results in a tax saving and not in a tax deferral (see page 17 of the I.R.S. letter). This Court, however, in *City of Los Angeles* v. *Public Util. Comm.* (1975) 15 C.3d 680, 686, 687, has recognized the true nature of this tax saving and cites therein the federal cases and other authorities which agree.

Given such demonstrated ignorance of the law, it is no wonder that the author of the I.R.S. letter was able to provide Pacific with the result it requested. As this Court already knows, Pacific's position to the I.R.S. was that Decision No. 87838, if allowed to become final, would result in loss of eligibility for use of accelerated depreciation (see page 6 of Pacific's letter to the I.R.S. attached to the answer filed jointly by the Cities of Los Angeles, San Diego, and the City and County of San Francisco). Faced with such an argument from the taxpayer, any other conclusion by the I.R.S. would have been surprising indeed.

Because the subject letter from the I.R.S. adds nothing to the issue of the lawfulness of Decision No. 87838, the Commission respectfully repeats its conclusion that the petitions for Writs of Review in these proceedings should be denied.

Very truly yours,

JANICE E. KERR
General Counsel

/s/ By WALTER H. KESSENICK
Principal Counsel

cc: All parties to S.F. No. 23746

WHK: gg

June 26, 1978

Honorable Rose E. Bird, Chief Justice
Honorable Mathew O. Tobriner, Associate Justice
Honorable Stanley Mosk, Associate Justice
Honorable William P. Clark, Jr., Associate Justice
Honorable Frank W. Richardson, Associate Justice
Honorable Wiley W. Manuel, Associate Justice
Honorable Frank C. Newman, Associate Justice

The Supreme Court of the
State of California
State Building
350 McAllister Street
San Francisco, California 94102

RE: S.F. No. 23746, Pacific Telephone v. PUC—Reply to letter of June 9, 1978 of Pacific Telephone

Dear Chief Justice and Associate Justices:

On June 9, 1978, Pacific Telephone mailed the Court a three-page letter and attached an 18-page letter to Pacific from Geoffrey J. Taylor of the IRS, Engineering and Valuation Branch. In its letter at page 1, Pacific took the position that its Petition to the Court presented the question of eligibility for tax benefits. It intimated that Mr. Taylor's letter deprived Pacific of such tax benefits.

It is the position of the City and County of San Francisco, and Cities of Los Angeles and San Diego (Cities) that tax eligibility is not a relevant issue before the Court, and furthermore that Mr. Taylor's letter to Pacific is in no way dispositive of the tax issue.

In the Cities' Answer, we have argued that the federal tax issues are not the primary issues of this case, and the sole issue before the Court is whether or not the Commission adopted a rate-making alternative consistent with the remand instruction of the Court in *City of Los Angeles* v. *Public Utilities Commission*, 15 C.3d 680 (1975). It is our position that the

Commission's decision should be sustained without regard to income tax eligibility. This argument was presented to the Court at pages 6-7 and 12-13 of the Cities' Answer.

This position is based on *City and County of San Francisco* v. *Public Utilities Commission*, 6 C.3d 119, 129-130 (1971) where the Court held that "even assuming the absence of the option" to use accelerated depreciation, flow-through was a lawful alternative. The Commission, consistent with the Court's remand instruction, has selected as a compromise, a ratemaking alternative far more favorable to the utility than flow-through. (Cities' Answer, pages 9-10.) Under these circumstances, tax eligibility is not a relevant issue in determining if the Commission decision is consistent with the Court's remand.

Mr. Taylor's letter to Pacific is in no way dispositive of the tax eligibility issue. The letter itself was in response to Pacific's request to be declared ineligible. Pacific's position to Mr. Taylor was:

> "It believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in good faith seek rulings that the Decision is consistent with those requirements." (Letter of Pacific to IRS, dated September 29, 1977, Cities' Answer, Appendix D.)

Under these circumstances, it was fully expected that an IRS employee, such as Mr. Taylor of the Engineering and Valuation Branch, would agree with Pacific.

Mr. Taylor's letter, although lengthy, provides no analysis of the eligibility issue. For the most part, it is merely a lengthy recitation of Pacific's position. Taylor provides no justification for his conclusions. No case law is ever cited, and no analysis of the issue is even attempted.

If the Court affirms the Commission's order, Pacific will have an opportunity to challenge any tax assessments via vari-

ous stages of internal review at the IRS, and via appeal to the Federal Courts. Arguments for eligibility which were not presented to or discussed by Mr. Taylor appear at pages 14-17 and Appendix C of the Cities' Answer. The Federal Courts, not Mr. Taylor, can determine Pacific's tax eligibility. If Pacific continues to seek ineligibility, there will not be an analysis of this issue.

Pacific has intentionally sought to be declared ineligible for accelerated depreciation. This is a calculated tactic, as Pacific has no other argument against the PUC order. Pacific's tactic is merely another example of "obstinacy" and "imprudent management." *City and County of San Francisco* v. *Public Utilities Commission, supra,* at 128, 129.

The Commission decision is harsh on ratepayers and rewards Pacific. (Cities' Answer, pages 9-10.) This further imprudence only provides grounds for the use of full flow-through. (Cities' Answer, pages 4-5.) Pacific's voluntary request for ineligibility does not improve its legal or equitable right to excessive rates based on phantom taxes.

Respectfully submitted,

CITY AND COUNTY OF SAN FRANCISCO

GEORGE AGNOST, City Attorney
LEONARD L. SNAIDER, Dep. City Atty.
CITY OF LOS ANGELES
BURT PINES, City Attorney
THOMAS C. BONAVENTURA, Asst. City Atty.
ED PEREZ, Deputy City Attorney
CITY OF SAN DIEGO
JOHN WITT, City Attorney
WILLIAM S. SHAFFRAN, Dep. City Atty.

/s/ By LEONARD L. SNAIDER

LLS:mg

cc: All parties to S.F. No. 23746

July 11, 1978

Honorable Rose E. Bird, Chief Justice
Honorable Mathew O. Tobriner, Associate Justice
Honorable Stanley Mosk, Associate Justice
Honorable William P. Clark, Jr., Associate Justice
Honorable Frank K. Richardson, Associate Justice
Honorable Wiley W. Manuel, Associate Justice
Honorable Frank C. Newman, Associate Justice

The Supreme Court of the
State of California
State Building
350 McAllister Street
San Francisco, California 94102

Re: S.F. No. 23746, Pacific Telephone v. PUC—Reply to letter of July 5, 1978 of Pacific Telephone

Dear Chief Justice and Associate Justices:

In a filing of July 5, 1978, Pacific Telephone provided the Court a decision of the Maine Supreme Court, *New England Telephone and Telegraph Co.* v. *Public Utilities Commission*, and argued at page 3 of its letter, "The decision supports our Petition." It is the position of the City and County of San Francisco and the Cities of Los Angeles and San Diego (Cities) that the decision provided by Pacific reinforces the Cities' contention that this case presents issues of intrastate ratemaking, and should and must be decided consistent with the principles of California law and the decisions of the California Supreme Court.

The case before the Court does not involve an interpretation of federal tax law. The Maine Supreme Court overturned the ratemaking treatment adopted by the Maine Public Service Commission. The Maine decision did not turn on a definitive interpretation of federal tax law.

"We need not reach this substantive issue at this time, because we decide this case upon state law concerning the power of the Commission. We hold that the Commission's actions with respect to the accelerated depreciation issue constitute an abuse of its power and discretion in the rate-making process." (Slip opinion at p. 21.)

In the instant case, the California Commission has acted consistent with the criteria of this Court in the *City of San Francisco* v. *PUC*, 6 C.3d 119 (1971) and the remand in the *City of Los Angeles* v. *PUC*, 15 C.3d 680 (1975). This argument was developed in full at pages 7-11 of Cities' Answer.

The Maine decision only reinforces our interpretation of the issues raised in this case, and leads to the inevitable conclusion that the case must be decided "upon state law."

Respectfully submitted,

GEORGE AGNOST, City Attorney
LEONARD L. SNAIDER, Dep. City Atty.

CITY OF LOS ANGELES
BURT PINES, City Attorney
THOMAS C. BONAVENTURA, Asst. City Atty.
ED PEREZ, Deputy City Attorney

CITY OF SAN DIEGO
JOHN WITT, City Attorney
WILLIAM S. SHAFFRAN, Dep. City Atty.

/s/ By LEONARD L. SNAIDER

LLS:mg

cc: All parties to S.F. No. 23746

APPENDIX C

HR 6659—*A BILL*

To confirm the purpose of the accelerated depreciation provisions of the Internal Revenue Code, and to avoid loss to the Federal revenues in the case of regulated taxpayers through the application of these provisions contrary to the intent of Congress.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That it was the intent of the Congress in providing the depreciation methods referred to in section 167(b)(2), (3) and (4) of the Internal Revenue Code to increase available working capital and assist the modernization and expansion of industrial capacity for all segments of the American economy, both regulated and non-regulated, and in order to limit the loss of Federal revenues to the accomplishment of these purposes, no agency, instrumentality, commission or other similar body with authority to establish or approve the rates of any taxpayer shall, without the consent of such taxpayer—

(a) specify, or prohibit a change of, the method of rate of depreciation, allowable under the Internal Revenue Code, to be used by such taxpayer in computing the amount of its Federal income tax;

(b) determine such taxpayer's expense for Federal income taxes paid, or to be paid, for any period in establishing such taxpayer's cost of service (either to determine its overall rate of return or to reflect operating results in its books of account)—

(1) by using, or considering the availability of, any method or rate of depreciation allowable under the Internal Revenue Code other than that used, or proposed to be used, by such taxpayer in computing its Federal income tax for such period,
or

(2) in the case of any taxpayer which uses, or pro-

poses to use, one of the methods or rates referred to in section 167(b)(2), (3) and (4), by excluding from such tax expense the amount of any reduction in Federal income tax payable for such period attributable to the allowance of such method or rate;

(c) accomplish a result similar to those proscribed by paragraph (a) or (b) by any other treatment, device, or procedure.

SEC. 2—Effective Date. The provisions of this bill shall apply on or after [the date of introduction of this bill].

(Page V Table of Authorities Cited Pacific Telephone Petition For Writ of Review S.F. No. 23746)

Constitutions, Codes, Regulations and Statutes

APPENDIX D

Appendix

THE PRESENT STATUS OF PACIFIC'S FEDERAL INCOME TAX LIABILITY

Pacific has claimed accelerated depreciation on its tax returns since 1970. The resulting tax deferrals have been invested in plant and equipment. The amounts are substantial:[1]

	1970	$ 6,917,000
	1971	38,029,000
	1972	56,090,000
	1973	71,502,000
	1974	91,017,000
	1975	108,494,000
	1976	117,880,000
Estimated	1977	130,285,000

If the Decision is inconsistent with eligibility for accelerated depreciation, the tax deferrals for the period impacted by the Decision will become currently due and payable.

Determination of the precise period impacted by the Decision requires review of several rate cases. First, the Decision affects rates established by two prior rate orders (Decisions 83162 in 1974 and 85287 in 1975). The rates set by the earlier order first went into effect August 17, 1974. The Decision adjusts the rates back to that date, and thus directly determines the question of eligibility for all periods subsequent to August 17, 1974.

In addition, we believe the Decision determines eligibility for the period from 1970 to August, 1974 as well, although it does not set the rates for that earlier period. Shortly after the

1. The evidence closed in mid-1976 and thus showed actual figures through 1975; however, the Decision used the "most recent estimates" apparently derived from the monthly reports filed by Pacific for 1976, e.g. Exhibit 10, Part 1 and Exhibit B to the Application for Rehearing. The amounts shown relate to the plant used for intrastate services or about 80% of total plant. The FCC's ratemaking is consistent with eligibility as to accelerated depreciation on interstate plant. In re Amendment of Part 31 etc., 24 F.C.C.2d 357 (1970); (Ex. 9, p. 23). The figures used here through 1976 are from Exhibit 10A; 1977 is Pacific's current estimate.

1969 Tax Reform Act went into effect, the Commission, in Pacific's Application No. 51774, held that it would follow the normalization method of accounting required by the federal law with respect to accelerated depreciation.[1] This was reversed[2] and the rates so established were subsequently annulled,[3] so that in the period from 1970 to August, 1974, the rates in effect were *not* based upon normalization. This may well give the IRS grounds for asserting a tax deficiency for this period. However, it may be argued that the Regulations[4] presuppose an initial grace period in which the regulatory Commissions may decide this issue. Thus, even though Pacific's rates were not based on normalization during this initial grace period (1970 through August, 1974), Pacific could still be eligible during the grace period if rates were subsequently set in accordance with eligibility.

There are no decisions involving this grace period and the length of time involved in resolving the matter is troublesome. The Commission has steadfastly held each time the issue was before it that it desired to maintain eligibility and use normalization, and this Court has not held to the contrary. Thus, there has been as yet no final resolution of the ratemaking treatment of accelerated depreciation. If the final decision in this case is consistent with eligibility, we believe that we would be eligible for the entire period since 1970. On the other hand, if this proceeding finally resolves the matter in a manner inconsistent with the requirements of the tax law, there will be little chance to avoid a current obligation for the entire tax liability from 1970 to date.

1. Decision 77984, 71 Cal.P.U.C. 590 (1970).

2. *City and County of San Francisco* v. *PUC*, 6 Cal.3d 119 (1971).

3. *City of Los Angeles* v. *PUC*, 7 Cal.3d 331 (1972).

4. Regs. §1.167(l)-1(h) (4).

The history with respect to the investment tax credit[1] is similar, but there are important distinctions. The ITC came into effect in 1972.[2] The amounts[3] of ITC claimed are:

	1971	$ 8,693,000
	1972	19,369,000
	1973	22,028,000
	1974	24,901,000
	1975	62,157,000
	1976	75,014,000
Estimated	1977	96,454,000

Pacific may only claim the investment tax credit if its rates are made consistent with "Option 2," which permits a ratable flow-through of the credit. The Commission approved this method in 1972 and that Decision became final.[4] The Commission again embraced Option 2 in 1974, but in its 1975 decision this Court directed the Commission to consider the matter further.[5] There is again a distinction between the back tax exposure before and after August 17, 1974. The pre-1974 approval of Option 2 gives comfort, but the legislative history and the statute indicate that any final adjudication that is inconsistent with eligibility destroys eligibility for all open tax years.[6]

The back tax exposure facing Pacific by the end of 1977 with respect to both accelerated depreciation and ITC totals more than $925,000,000; with interest it exceeds one billion dollars.

1. 26 USCA §§ 38, 46.

2. Revenue Act of 1971, 85 Stat. 503, 26 U.S.C.A. § 46.

3. The ITC was initially 4%; in 1975 is was increased to 10%. The amounts shown relate to the ITC associated with plant additions used for intrastate service (about 80% of plant additions); the FCC's rate-making is consistent with eligibility for the ITC associated wtih interstate plant (Ex. 9, p. 23).

4. Decision 79873, 73 Cal.P.U.C. 222 (1972), writ of rev. den. (S.F. No. 22968 and 22969, November 15, 1972).

5. Decision 83162 —— Cal.P.U.C. —— (1974), rev'd in part *City of Los Angeles* v. *PUC*, 15 Cal.3d 680 (1975).

6. I.R.C. § 46(f)(4); Senate Report 92-437, 92d Cong., 1st Session p. 1948 [Exhibit A, Tab 32].

INTERNAL REVENUE SERVICE
DEPARTMENT OF THE TREASURY
Washington, D.C. 20224

Person to Contact: A. L. Woodman

Telephone Number: 202-566-3392

Refer Reply to: T:C:E:A:3

Date: 11 Jan. 1977

Public Service Commission
State of New Mexico
Battan Memorial Building
Santa Fe, New Mexico 87503

Attn: Hon. Richard P. Montoya,
Chairman

Dear Chairman Montoya:

This responds to your December 17, 1976 letter request with related material submitted on behalf of the Commission for a ruling on an issue arising under section 40 of the Internal Revenue Code of 1954 (Code) for which final regulations have not yet been adopted.

The issue involves the proper regulatory accounting treatment for investment credit under section 46(f) of the Code (redesignated from section 46(e) of the Tax Reduction Act of 1975) and is currently pending in a rate regulatory proceeding before the Commission. The proceeding was convened by reason of a petition filed by (company name deleted) for an increase in its service rates subject to the ratemaking jurisdiction of the Commission.

We regret that a ruling as requested cannot be issued. This is because it is the general practice of the Service to rule only under the procedures set out in Rev. Proc. 72-3, (1972-1 C.B. 698), copy enclosed. However, when appropriate and in the interest of sound tax administration, the Service will provide

an information letter in answer to inquiries where it is believed that general information on a particular subject may be of assistance. An information letter does no more than call attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. This response is considered to be such a letter.

In your letter, the question involved in stated to be whether or not in the circumstances presented, the Commission may delete from the Company's capital structure the accumulated deferred investment tax credit without resulting in a loss of credit to the Company.

The circumstances are understood to be there. The Company is a "regulated public utility" as defined in section 7701 (a)(33) of the Code: it holds "public utility property" within the meaning of section 46(c)(3) of the Code; certain of the property qualifies for the investment tax credit under the provisions of section 1.46-3(g) of the regulations; and the Company exercised a proper and timely election as provided by section 46(e)(2) (now section 46(f)(2)) of the Code as to the preferred accounting treatment of the credit for ratemaking purposes. The effect of this election from the standpoint of investment tax credit availability is noted in the discussion of the basic question set out in the later part.

It is further understood that in the rate proceeding before the Commission, the Company proposed that for ratemaking purposes, the reserve for accumulated deferred investment tax credit be included with the common stock in th derivation of the Company's composite capital structure for use by the Commission in the determination of an overall rate of return to be applied to the utility rate base. Because the Commission does not contemplate any direct adjustment to the utility rate base, the inquiry centers on the question of whether or not the Company's proposal should be accepted as proper in order that the availability of the investment credit not be jeopardized.

The inquiry is answered in affirmative based upon the effect of the Company's election under section 46(f) (2) of the Code. Upon the exercise of this option, the investment credit is not to be available to a utility with respect to any of its otherwise qualified public utility property if: (a) there is any adjustment to reduce the rate base; or (b) if the credit to which it would otherwise be entitled is flowed through faster than ratably in the period of time over which depreciation expense is computed on the utility's regulated books of account.

In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect a utility's permitted return on investment by treating the credit in any way other than as though it had been contributed by the utility's common shareholders. This means that the cost of capital rate assigned to the credit cannot be less than the rate assigned to the common shareholders' investment. If a lesser rate were to be so assigned, it would be treated as, in effect, a rate base adjustment and the credit would be unavailable.

Accordingly, in determining the overall cost of capital of a utility for ratemaking purposes, deferred investment tax credits are properly to be included and assigned a rate *not less than that considered applicable to common equity.* It follows that the *unamortized investment* credit, or that portion of the credit which has not yet been flowed through to income is appropriately to be included in the total capital of a utility on which a rate of return is to be allowed.

This procedure implements the intent of the Congress that the benefits of the credit be shared between investors and customers. While a utility would be permitted to earn a return on the unamortized investment credit, the ratable amortization of the credit reflected in the utility's cost of service would result in increased revenue for ratemaking purposes with a corresponding reduction in the utility's rates.

Very truly yours,

/s/ GEOFFREY J. TAYLOR
Acting Chief, Engineering and
Valuation Branch

In the Supreme Court
OF THE
United States

October Term, 1978

No. 78-606

The Pacific Telephone and Telegraph Company,
Petitioner,
vs.
The Public Utilities Commission of the
State of California, and Robert Batinovich,
Vernon L. Sturgeon, Richard D. Gravelle,
Claire T. Dedrick, and William Symons, Jr.,
the members of said Public Utilities Commission, et al.,
Respondents.

No. 78-607

General Telephone Company of California,
Petitioner,
vs.
The Public Utilities Commission of
the State of California, et al.,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of the State of California

BRIEF FOR RESPONDENT PUBLIC UTILITIES COMMISSION IN OPPOSITION

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BRIEF FOR RESPONDENT PUBLIC UTILITIES COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinions below are correctly set forth in the Petitions.

JURISDICTION

Jurisdiction is alleged under provisions of Title 28, Section 1257(3). As hereinafter shown, the respondent

Public Utilities Commission challenges jurisdiction on the grounds that the petitions are inadequate to show how and in what manner federal questions were properly and timely raised in the State Supreme Court.

QUESTION PRESENTED

Whether an order of the California Public Utilities Commission (Commission) that The Pacific Telephone Company (Pacific) and General Telephone Company of California (General) refund money to their ratepayers and reduce their current rates to reflect a portion of their reduced federal income tax expenses violates the equal protection clause of the 14th Amendment.

As explained in more detail hereinafter, the additional question of violation of the Supremacy Clause of Art. VI, raised by Pacific, is not properly before this Court.

STATUTES AND REGULATIONS INVOLVED

The pertinent provision of the Internal Revenue Code (IRC) of 1954 as amended, 26 U.S.C. §§ 167(e) and 46(f) are reprinted in Appendix C of the Petitioners' Joint Appendix (Pet. App.) as are the applicable Treasury Regulations, 26 C.F.R. §§ 1.167(1)—1(h)(1) and (6).

STATEMENT

This litigation concerns a decision of the Commission, Decision No. 87838, issued September 13, 1977. In that decision the Commission ordered Pacific and General to reduce rates and make refunds of money previously collected subject to refund. The basis for these reductions and refunds was a determination that Pacific's and General's reasonable expenses for federal income tax

could lawfully be computed by making an averaged annual adjustment (AAA) to reflect changes in the deferred tax reserves resulting from Pacific's and General's use of accelerated depreciation to figure depreciation expense and an annual adjustment (AA) to reflect the effect of their use of option 2 (ratable flow through) to figure Investment Tax Credit (ITC).[1]

In two previous decisions, the Commission had concluded that it had no lawful alternative to setting Pacific's and General's rates on a normalized basis, i.e. to reflect income tax expense as though it had been incurred on a straight line depreciation basis rather than on an accelerated depreciation basis.

Both of these decisions were subsequently annulled by the California Supreme Court on grounds that the Commission had not fully considered its lawful ratemaking alternatives.[2]

Among those alternatives, the California Court went on to state, were an adjustment to rate of return or an end-of-year adjustment to rate base. The Court also held that imputed flow-through could be considered and would not violate Pacific's 14th Amendment guarantee of due process in view of the telephone utilities' past imprudence in not taking advantage of tax benefits when they were

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[1]The AAA and AA methods are fully described and explained in Decision No. 87838, Appendix B to Pet. App, at pages 25A-31A and thus need not be repeated in full here.

[2]*City and County of San Francisco v. Public Utilities Commission*, 1971, 6 C.3d 119; *City of Los Angeles v. Public Utilities Commission*, 1975, 15 C.3d 680 (Appendix A of Respondents' Joint Appendix [Resp. App.]).

available to them.[3] In Decision No. 87838 the Commission has adopted an equitable compromise, fair to both the curent taxpayer and the utility.

In Decision No. 87838 the Commission concluded that use of the AAA and AA methods was not precluded by law and would not cause Pacific and General to lose eligibility for the tax benefits at question.

Pacific and General petitioned the Commission for rehearing of Decision No. 87838, which petitions were denied. Thereafter they filed separate petitions in the California Supreme Court for writ of review.[4] Those petitions were separately denied, without opinion, by that court on July 13, 1978. (Appendix A of Pet. App.).

REASONS FOR DENYING THE WRIT

I

THE PETITIONS ARE INADEQUATE TO RAISE A FEDERAL QUESTION BECAUSE THEY LACK SPECIFICITY.

Both petitions seek review of a judgment of the California Supreme Court. Rule 23.1(f) of this Court's rules provides in pertinent part:

> ". . . If review of the judgment of a state court is sought, the statement of the case shall also specify the stage in the proceedings in the court of first instance and in the appellate court, at which, and

[3]*City and County of San Francisco v. Public Utilities Commission*, supra at p. 129.

[4]S.F. No. 23743, *General Tele. of Calif., v. Public Util. Comm.;* S.F. No. 23746, *The Pacific Tele. & Tele. Co. v. Public Util. Comm.*

> the manner in which, the federal questions sought to be reviewed were raised; the method of raising them (e.g., by a pleading, by request to charge and exceptions, by assignment of error); and the way in which they were passed upon by the court; such pertinent quotations of specific portions of the record, or summary thereof, with specific reference to the places in the record where the matter appears (e.g., ruling on exception, portion of the court's charge and exception thereto, assignment of errors) as will show that the federal question was timely and properly raised so as to give this court jurisdiction to review the judgment on writ of certiorari."

General's petition is totally inadequate to show when and how it raised the federal question before the California Supreme Court. General merely states that, in its petition to that court, it asserted, ". . . that the order threatened to deprive General of its property without due process of law . . ." (General's petition at page 16). Such a statement fails to provide the specific information, references and quotations required by Rule 23.1(f).

Pacific's petition, in a footnote on page 11 thereof, asserts that it raised federal questions before the Commission and, in another footnote on page 12 thereof, that it raised constitutional questions before the California Court. As shown in more detail hereafter, the latter footnote is at least inaccurate and at worst misleading. However for purposes of this argument it is sufficient to note that Pacific failed to provide:

> ". . . such pertinent quotations of specific portions of the record or summary thereof . . . as will show that the federal question was timely and properly raised . . ." (Rule 23.1(f)).

Therefore Pacific's petition is inadequate to show that jurisdiction has been given this Court to review the judgment on writ of certiorari.

II

PACIFIC'S ALLEGATION THAT THE CALIFORNIA DECISION IS AT ODDS WITH THE SUPREMACY CLAUSE OF ARTICLE VI OF THE U.S. CONSTITUTION IS NOT PROPERLY RAISED BECAUSE PACIFIC FAILED TO RAISE THAT ALLEGATION IN THE CALIFORNIA COURT IN A TIMELY AND PROPER MANNER.

Title 28, Section 1257(3) requires by its terms that the federal question be ". . . drawn in question." This requirement speaks to jurisdiction and may be fulfilled only by a showing that the federal question was raised below in a timely and proper manner, *Walters v. City of St. Louis, Mo.*, 1954, 347 U.S. 231. The proper manner of raising the federal question is dependent upon state practice; *Beck v. Washington*, 1962, 369 U.S. 541, 549.

Pacific failed to raise this question in its petition to the California Supreme Court for a writ of review of the Commission's Decision. That petition, which under California rules constitutes Pacific's brief on the merits, contains absolutely no reference to Article VI nor was Article VI included in its Table of Authorities in said petition (Resp. App. C at page 73 RA). Pacific's first mention of Article VI of the California Court was in its reply brief to the Commission's answer.[5] That was not a timely nor

[5]Pacific's footnote No. 15 on page 12 of its petition is so loosely worded that it is misleading. Pacific seems to be asserting that it raised both the 14th amendment and the Article VI questions in its petition for writ of review to the California Supreme Court: In point of fact, however, it raised only the 14th amendment question.

a proper manner of raising the question under California law, *Radinsky v. Thomas (T.W.) Inc.*, 1968, 264 Cal. App.2d 75.

Pacific can take no comfort from the fact that General raised the question in its own petition to the California Court. The two petitions were separately filed and briefed by the petitioners and were denied in separate orders by the California Court, (Appendix A, pages 1A and 2A of Pet. App).

General, which could now raise the question, has not done so.

In any event, the Commission has not violated federal law in its decision nor is its decision in conflict with such law. IRC Sections 46 and 167 are directed to the taxpayer, not to the Commission.

In 1969, legislation was proposed to restrict ratemaking actions of federal and state regulatory agencies. However such restrictions were specifically not enacted in view of the constitutional problems as expressed by Chairman Mills during the hearings.

> "I understand your legal point, that we have no right to tell you how to fix rates on intrastate matters in the State of California. I agree with you, that would be an invasion of your right." (Hearings on HR6659, House Committee on Ways and Means, p. 3887, 91st Congress (1969).)

There being no act by the Commission in violation of a federal law nor against the intent of Congress, no violation of the Supremacy Clause is shown.

III

THE JUDGMENT BELOW IS CLEARLY CORRECT.

The AAA and AA methods at question are a lawful exercise of the Commission's jurisdiction and conform to the applicable tax laws and regulations.

A. Accelerated Depreciation

Decision No. 87838 concludes that Pacific and General must use "normalized" accounting procedures to be eligible to use accelerated depreciation and that the AAA method conforms to the strictures on such procedures in IRC Section 167.1 and in Treasury Regulation 1.167(e)-(1)(h)(6). (see Pet. App. at pages 25A-28A). Unable to show that use of the AAA method is prohibited by the express language of those sections, Pacific and General urge that violation nevertheless results because the effect is to reduce the rate base by more than the amount of the addition to the tax reserve inasmuch as the tax expense and the growth of deferred tax reserve are not estimated in the same manner. But the law and the regulations do not specify the manner of estimating the tax expense and tax reserve, merely that they be estimated for the same time period. It is uncontested that the AAA method does exactly that.

Furthermore, the AAA method recognizes that the growth of the deferred tax reserve varies out of all relationship to the changes in other elements of Pacific's and General's expenses and revenues. It therefore holds those other elements constant when estimating a future change in tax expense and deferred tax reserves. As Decision No. 87838 explains (Pet. App. B at pages 27A, 28A) assuming constants is a common and lawful aspect of ratemaking.

B. ITC

As discussed in Decision No. 87838 (Pet. App. at pages 28A-31A), the AA method sets rates for an estimated test year by deducting the rateable amount of the ITC for that year from tax expense and makes annual adjustments thereafter to reflect subsequent changes in such expenses. The IRC does not impose any specific method on the Commission for determining the correct ratable amount to be deducted. Nevertheless, as with accelerated depreciation, Pacific and General allege that loss of eligibility will occur because of the possibility that a use of the AA method may result in a greater than ratable amount being deducted in years after the test year. The Commission does not concur. An annual adjustment clearly meets the requirements of the IRC Section 46(f)(2). However, as with accelerated depreciation, only the future will disclose whether or not a loss of eligibility will result or what tax deficiency, if any, will be assessed by the IRS or upheld by a competent court.

IV

THERE IS NO IMPORTANT QUESTION OF FEDERAL LAW.

Contrary to assertions by Pacific and General that the question raised has broad, national significance, the fact is that the ratemaking decision at issue applies only to them and was developed specifically to deal with the problems arising from their past refusal to adopt accelerated depreciation with flow-through between 1954 and 1970 (a refusal the Commission and the California Court found to be imprudent)[6] and their subsequent decisions to adopt accelerated depreciation with normalization under provisions of the Tax Reform Act of 1969.

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[6]Decision No. 87838, p. 45A of Pet App.; *City and County of San Francisco v. Public Utilities Commission*, 1971, 6 C.3d 119, 129.

The Petitioners' predictions of a bandwagon effect are mere supposition. The Commission's ratemaking methods at issue here have not been utilized by any other regulatory agency. In fact, a review of Decision No. 87838 and the decisions of the California Supreme Court which preceded it[7] shows clearly that Decision No. 87838 has a unique history, not likely to be duplicated.

Furthermore, there is no reason to believe that a denial of a writ of certiorari would encourage other agencies or courts to follow the California example. Such a denial is not a judgment on the merits nor a precedent for like action in a similar case, *Wade v. Mayo*, 1948, 334 U.S. 672, 680.

V

THE JUDGMENT BELOW DOES NOT VIOLATE THE DUE PROCESS GUARANTEES OF THE FOURTEENTH AMENDMENT.

Pacific alleges that the judgement below is in conflict with the holding in *West Ohio Gas Co.* (No. 2) *v. Public Utilities Commission,* 1935, 294 U.S. 79, in which a rate reduction order was held to be constitutionally defective because the regulatory agency relied exclusively on 1929 data in setting rates for 1933, ignoring available revenue and expense data for 1930 and 1931.

A fair reading of Decision No. 87838 shows that the Commission did not ignore available data (see Pet. App. at pages 35A, 36A). Moreover, the rates in question have been specifically subject to refund. The California Supreme Court annulled and remanded the Commission's earlier de-

[7]*City and County of San Francisco v. Public Utilities Commission*, 1971, 6 C.3d 119; *City of Los Angeles v. Public Utilities Commission*, 1975, 15 C.3d 680, (Appendix A of Resp. App.).

cisions specifically to consider these tax questions. No such facts were present in the *West Ohio* case nor was the defendant there dealing with a future test year as was the Commission. The *West Ohio* case is clearly irrelevant.

Pacific and General further allege, but cannot show, that the judgment below is constitutionally defective because it will result in loss of their eligibility for tax reductions both under Section 167(e) of the Internal Revenue Code of 1954 as amended (accelerated depreciation) and Section 46f thereof (ITC). Such a loss of eligibility, it is alleged, will be retroactive for the years not yet audited by the Internal Revenue Service (IRS) as well as prospective and will result in higher tax expenses than those provided for in rates. This in turn, it is alleged, will be destructive to the petitioner's financial integrity.

Pacific's allegation that its financial integrity will be destroyed if the judgment below is allowed to stand is simply a continuation of scare tactics which it has repeatedly used before this Court and the California Court. Pacific has always predicted that financial disaster would result if its own proposals for dealing with tax expenses were not adopted. The simple fact is that such disasters do not occur.

Insofar as such predictions relate to refunds and rate reductions, as far back as 1972 Pacific argued to this Court that a decision of the California Supreme Court should be stayed because, ". . . The amount involved is so large as to have a serious adverse effect on the petitioner's financial condition and its ability to serve the public."[8]

[8]A69, *Pacific Telephone Co. v. City of Los Angeles,* denied July 28, 1972 by Justices White and Renquist.

On still another occasion Pacific told the Commission that adopting flow through would result in "... degradation of service and possible financial collapse," and that the "... utilities would go bankrupt."[9]

However Pacific changes this scenario at will. For example, when a ratepayer petitioned in the California Supreme Court for a stay of a rate increase pending resolution of these very income tax questions, Pacific opposed the stay and specifically represented to the Court that, should the tax questions be resolved adversely to Pacific, it would be able to make refunds. "Pacific is financially capable of any such refunds," the Court was told. Pacific further cited its experience in being able to make refunds in the past.[10]

Insofar as Pacific's predictions relate to a loss of eligibility for the tax benefits at issue, the fact is that no such loss of eligibility has occurred. No tax deficiency has been assessed. The (IRS) letters (Pet. App. at page 95A et seq), relied on by Pacific and General, are neither determinative of eligibility nor binding on either the IRS or the taxpayer.[11]

Furthermore, the IRS itself is not proceeding in accordance with those letters. Pacific's petition to this Court includes, on page 21, an estimate of potential tax liability beginning with the year 1974. This is most significant. Pacific told the California Supreme Court that it was

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[9]*City of Los Angeles v. Public Utilities Commission,* 15 C.3d, 1975, 680, 688 (Sesp. App. A at page 26 RA).

[10]*Bennett, et al. v. Public Utilities Commission,* S.F. No. 23180.

[11]Pacific, as a subsidiary of The American Telephone & Telegraph Co. (AT&T) files a consolidated tax return. No allegation has been made that AT&T would lose eligibility as a result of the judgment below. The same facts obtain as to General and General Telephone and Electronics (GTE).

faced with a potential tax liability beginning with the year 1970, not 1974, even though Pacific knew at that time that the IRS had closed the books on 1970, finding no tax deficiency.

Now Pacific begins its estimate with 1974, not bothering to explain that the IRS has recently completed its tax audit for the additional years of 1971, 1972 and 1973, again with no assessment of deficiency.

It is especially significant that the last date upon which the IRS could have assessed a deficiency for those years or extended the period of limitation was June 30, 1978, three weeks after the IRS letters regarding accelerated depreciation were issued, and that the IRS did not extend that period.

The above instance is merely one example wherein the federal government's position on these matters of eligibility for income tax benefits has been confusing and contradictory. This has caused problems for the Commission in carrying out its mandated regulatory duties and subjected the parties to expensive and burdensome litigation.

Additional contradictions include:

1. A letter dated January 11, 1977 from Mr. Geoffrey Taylor of the IRS to the New Mexico Public Service Commission (Resp. App. D at page 78 RA et seq.) in which Mr. Taylor concluded that a utility would lose eligibility for Job Development Investment Credit (JDIC) unless, "... in determining the overall cost of capital of a utility for rate making purposes, deferred investment tax credits are properly to be included and assigned a rate not less than that considered applicable to common equity."

2. The IRS ignored this conclusion during its 1971-1973 audit and did not challenge Pacific's treatment of JDIC even though that treatment did not conform to Mr. Taylor's letter.

3. The Federal Energy Regulatory Commission, in Carolina Power and Light, Docket No. ER76-495 (Phase II Opinion 19, Aug. 12, 1978, printed in 15 Federal Power Service 5-619, 624, concluded that the above quoted statements in Mr. Taylor's letter ". . . do not represent a correct interpretation of the requirements of Section 46f."

4. The General Services Administration and the Secretary of Defense, on behalf of the consumer interests of all the executive agencies of the United States, filed a brief with the Commission during the proceedings which culminated in Decision No. 87838. In that brief the federal government's position was that the Commission could adopt a "pro-forma normalization" of Pacific's deferred tax reserves because such a method would conform to the applicable provisions of the IRC. Pro-forma normalization was discussed in Decision No. 87838 (Pet. App. at page 17A). That position is in direct opposition to the conclusions contained in two IRS letters, by the same Mr. Taylor, which Pacific and General rely on for their allegations that they will lose their eligibility to use accelerated depreciation.

The Commission is confident that the judgment below is correct. However, the above listed confusions and uncertainties cry out for an early resolution. It would benefit

all parties as well as Pacific's and General's ratepayers if this Court would hear and decide the issue of tax eligibility in favor of the Commission now.

CONCLUSION

For the foregoing reasons it is respectfully submitted that these petitions for a writ of certiorari should be denied.

November 13, 1978.

Respectfully submitted,

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In the Supreme Court of the United States

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BRIEF IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

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Respondents.

BRIEF IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

Respondents, the City and County of San Francisco, the City of Los Angeles, and the City of San Diego (Cities), were parties in the California Supreme Court proceedings, subject of the Petitions in No. 78-606 and No. 78-607. The Cities respectfully present this "Brief in Opposition to Petitions for Writ of Certiorari".

PRELIMINARY STATEMENT

San Francisco and San Diego receive telephone service from the Pacific Telephone and Telegraph Company (Pacific), and Los Angeles' service is from both Pacific

and the General Telephone Company of California (General).

The California Supreme Court orders of July 13, 1978, subject of the instant petitions, are the culmination of years of litigation. Prior to those orders, the issue of a reasonable allowance for prudently incurred income tax expense for the purpose of computing intrastate rates was the subject of eleven California Public Utility Commission (PUC) cases or applications,[1] three unanimous written California Supreme Court decisions,[2] and one application to the United States Supreme Court for stay.[3] One or all of the Cities were parties to each of these proceedings. The Cities prevailed in all of the court proceedings.

OPINIONS BELOW

The decisions of the PUC and the California Supreme Court, cited in the "Opinions Below" sections of the petitions of Pacific and General, follow multiple remands of this issue from the California Supreme Court. The opinions below can only be analyzed in conjunction with the full unanimous written opinions of the California Supreme Court in *City of San Francisco* v, *Public Utilities Commission* 6 C.3d 119 (1971) and *City of Los Angeles* v. *Public Utilities Commission* 15 C.3d 680 (1975) (*San Francisco* and *Los Angeles II*). These decisions appear at Appendix A of Respondents' Joint Appendix (cited as R.App.) pp 1RA-51RA.

1. PUC cases listed in Petitioners' Appendix B (cited as P.App.) pp 3A-5A.

2. *City and County of San Francisco* v. *Public Utilities Commission*, 6 Cal. 3d 119 (1971); *City of Los Angeles* v. *Public Utilities Commission*, 7 Cal.3d 331 (1972); *City of Los Angeles* v. *Public Utilities Commission*, 15 Cal.3d 680 (1975) (hereafter cited as *San Francisco, Los Angeles I* and *Los Angeles II*).

3. Application of Pacific to stay refund order in *Los Angeles I*, No. A69, October Term 1971, *Pacific Telephone* v. *City of Los Angeles*. Filed July 13, 1972. Denied by Justice White and Justice Rehnquist July 28, 1972.

QUESTIONS PRESENTED

Pacific contends at pp. 2-3 that the rate making method adopted by the California Supreme Court is in violation of the Supremacy Clause of the United States Constitution and deprives it of Fourteenth Amendment rights. General at page 2 of its petition adopts Pacific's Fourteenth Amendment argument, but did not adopt the Supremacy Clause argument, and asks the Court to issue an opinion on the question of whether the rate making methods adopted by the California Supreme Court will deprive Pacific and General of their eligibility under the Internal Revenue Code to continue the use of accelerated depreciation and the investment tax credit (JDIC).

The Cities contend that the relevant questions arising from the California decisions are simply (1) whether the rate making methods adopted by the PUC are consistent with the criteria set forth in California law as interpreted by the California Supreme Court, irrespective of federal income tax eligibility consequences, and (2) whether an intrastate rate making body may take into account managerial imprudence in setting intrastate rates. It is submitted that there are no substantial Federal questions raised in these issues and that the Petitions for Writ of Certiorari should be denied.

STATEMENT

The statements of the "Proceedings Below" by General (pp 9-10) and Pacific (pp 8-12) are at best incomplete. The history of these proceedings is lengthy and complex[4]. It will be briefly summarized in this section with respect to Pacific and the accelerated deprec-

4. The California Supreme Court in a section captioned "*1. The background of the present litigation*" in Los Angeles II at R.App. A, pp 21RA-32RA, presents a comprehensive history through 1975.

iation issue. The facts and law relevant to General and the investment tax credit (JDIC) issue are similar and will not be discussed in detail either in this section or throughout the brief.

The cases involve criteria to be applied by the PUC in setting telephone rates by determining what expenses Pacific and General may pass on to their consumers. Both Petitions arise from a series of rulings of the California Supreme Court (see fn. 2) which basically hold that a public utility owes a duty to its consumers to minimize its expenses, including tax expenses. The California Supreme Court has decided, as a matter of state law, that it is managerial imprudence for a public utility willfully to subject itself to a greater tax liability than it is legally required to pay. Customers need not compensate utilities for imprudent expenses.

Thus the California Supreme Court has ruled in 1971 that the PUC may set rates as if prudent options had been exercised. It is the PUC's 1977 rate setting action pursuant to California Supreme Court decisions that is before this Court.

The use of accelerated depreciation for tax purposes provides a utility a substantial tax saving. The amount of savings grows at a substantial rate so that the tax saving resulting from accelerated depreciation in one year is not representative of the far higher savings in future years. From the inception of the tax law in 1954 permitting accelerated depreciation there has been a debate over the proper method of taking into account accelerated depreciation for ratemaking purposes. This debate was summarized by the California Court in *Los Angeles I*:

> "The problem presented is whether the tax saving or tax deferral should inure to the benefit of the ratepayer in the form of lower rates or whether the tax saving or deferral should be retained by the utility with no reduction in rates. When the saving is passed on to ratepayer, the accounting procedure is called accelerated depreciation with flow through. When the saving is retained by the utility, the accounting procedure is called accelerated depreciation with normalization."[5] (footnotes omitted) 7 Cal.3d at 338, 339.

For ratemaking purposes in the 1960's the PUC adopted the flowthrough method and all major utilities in California with the exception of Pacific and General accepted accelerated depreciation for tax purposes and passed on the considerable savings to the ratepayers via the flow through method. (*San Francisco* at R.App. A, p 6RA) Pacific and General refused to take advantage of the tax savings. They chose to pay higher taxes on the straight line basis. (id at 7RA)

Faced with this situation the PUC concluded in 1968 that the rates Pacific could charge its customers should be calculated on the premise that Pacific could have and should have chosen accelerated depreciation and that the benefit of this method, regardless if it was chosen, should be passed on to the consumers through the ratemaking mechanism. The California Supreme Court in 1971 summarized this situation in this manner:

> "On November 6, 1968, in Decision No. 74917 the commission determined that Pacific's management was imprudent in not electing to take accelerated depreciation for income tax purposes. The commission concluded that it could not compel Pacific to take the accelerated depreciation on its federal income tax return, but it held that for purposes of rate making Pacific would be treated as if it had

5. Normalization and flowthrough are *rate setting* terms. Both relate to identical tax methods of calculating depreciation.

obtained the tax saving of accelerated depreciation and the saving would be flowed through to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow through.) Notwithstanding this, Pacific continued to determine its federal tax liability using straight line depreciation." (San Francisco, supra, at R.App. A, p 7RA)

Pacific did not challenge the 1968 PUC order before the California Court. Instead it successfully lobbied for a change in tax legislation[6] I.R.C. 167(l)—P.App. C, pp 79A-81A) was the result. After this legislation passed, Pacific in 1970 adopted accelerated depreciation for tax purposes.

Under Pacific's interpretation of this law, companies that were on flow through could remain on flow through, but a company such as Pacific which never used accelerated depreciation could only obtain the tax benefits of accelerated depreciation if it was permitted to use the normalization method of accounting.

Pacific next persuaded the PUC, in Decision No. 77984, to permit it to use accelerated depreciation with normalization, on the basis that tax law precluded the Commission from adopting the flow through method.

On November 26, 1971, the California Supreme Court in *San Francisco* annulled PUC Decision No. 77984. In taking this action the Court repeatedly stressed that Pacific's management was "imprudent" in failing to elect to use accelerated depreciation and was "obstinate" in its continuing imprudent policy, (id.

6. The legislation originally supported by the Bell System in 1969 was H.R. 6659 (R.App. C, pp 71RA-72RA). This bill restricted state regulatory authority. Congress did not restrict regulatory agencies' rate making authority as had been proposed in HR 6659, in view of the constitutional problems indicated by Chairman Mills in response to objections of the PUC. "I understand your legal point, that we have no right to tell you how to fix rates on intrastate matters in the State of California. I agree with you, that that would be in invasion of your right." (Hearings on HR 6659, House Committee on Ways and Means, p. 3887, 91st Congress (1969).)

at R.App. A, pp 11-RA-15RA). The Court further found that the so-called normalization method which the PUC had adopted requires ratepayers to put up the capital for the telephone system "contrary to the basic principle of utility rate setting," (id. at R.App. A, p 13RA). In addition, the Court recognized that the effect of normalization "is to reward Pacific for its imprudent management" and is "harsh on the ratepayer" (R.App. A, p 15RA). The Court held that the PUC misapprehended its powers under the state law by not realizing it was empowered to set rates which held the company rather than consumer liable for failure to pursue a depreciation method which reduced tax expense. The Court concluded that the Commission could set rates for Pacific notwithstanding the change in the federal tax statute (R.App. A, p 11RA). The Court specifically pointed out that flow through or a compromise method could lawfully be applied by the PUC and directed the PUC to further consider the proper method for rate making purposes in light of the California Supreme Court's discussion of the options available to the PUC.

Despite the California Supreme Court's specific annullment of the Commission's use of normalization, the Commission continued to set rates on the basis of normalization.

On June 9, 1972, in *Los Angeles I*, the California Supreme Court ordered the Commission to reset rates on a flowthrough basis, both retroactively and prospectively. On July 13, 1972, Pacific filed an application with the United States Supreme Court to stay *Los Angeles I* (*Pacific Telephone* v. *City of Los Angeles*, No. A69). In that application, Pacific told the United States Supreme Court, "The Internal Revenue Service undoubtedly will assert that under the Tax Re-

form Act of 1969 petitioner must compute and pay its federal income taxes for this period, on the basis of straight line depreciation." (No. A69, page 19.) It complained that the refunds were so large as to have serious adverse effect on petitioner's financial condition and its ability to serve the public." (Id at p. 19, fn. 27.) Justice White and Justice Rehnquist each denied Pacific's application on July 28, 1972. Although Pacific's application for a stay was "pending filing of a petition for a writ of certiorari" (Application pages 1-2), no petition was ever filed. The PUC then reset Pacific's rates on flowthrough and ordered refunds of $176,000,000 and rate reductions of $90,000,000 per year.

On September 19, 1972, Pacific reapplied to the PUC to increase its rates. The disposition of that application is before the Court. For income tax purposes, Pacific continued to use accelerated depreciation, which it commenced in 1970. In Decision No. 83162, dated July 23, 1974, the PUC again set Pacific's rates on the identical basis of normalization that had been overturned by the California Supreme Court in *San Francisco* and *Los Angeles I.*

This rate increase was challenged by various parties. In response to a request that the rate increase be stayed, Pacific informed the California Supreme Court that "it was financially capable of any such refund", citing its experience in its refunding in *Los Angeles I.* (p 7, Pacific Memorandum, August 16, 1974.) The Court, in response to Pacific's memorandum, allowed Pacific to collect the full rate increase subject to refund.[7]

The California Supreme Court reviewed the PUC's

7. Pacific's rates have been collected subject to refund since 1974; General's rates have been subject to refund since 1971. The PUC refund orders are stayed pending disposition of this proceeding.

rate treatment of both Pacific and General and again remanded the tax issue to the PUC in *Los Angeles II*, issued in December 1975. The Court stressed in particular that the PUC had not looked at all relevant alternatives and suggested that so-called annual adjustment method could be adopted.

After this remand, the PUC in Decision 87838 (P. App. B) finally adopted a method of ratemaking as directed by the California Supreme Court. It approved a normalization method after safeguards were incorporated into the calculations to preclude Pacific and General from experiencing windfall profits. (Findings 3 and 4, P. App. B pp. 45A-46A.) This method is virtually identical to the annual adjustment method approved in Los Angeles II (R.App. A, pp 33RA-46RA). The PUC recognized that the growth in the normalization reserve for both accelerated depreciation and investment tax credit was abnormal. (Finding 5, P.App. B., p. 46A.) Failure to recognize such growth yields earnings in excess of those based on a normalization basis. Refunds and rate reductions were ordered based on this tax treatment.

PT&T and General sought review of Decision No. 87838. The Cities defended the PUC order on the grounds it was consistent with the remand instructions of the California Supreme Court. The California Supreme Court denied Pacific's and General's petitions for writ of review on July 13, 1978. The instant petitions to this Court followed.

SUMMARY OF ARGUMENTS

I. The Court Should Not Issue An Advisory Opinion On Tax Eligibility.

A. Adequate grounds, independent of the tax eligibility issue, were raised before the California

Supreme Court that could form the basis for its decision.

B. There is presently no tax controversy over the eligibility of General and Pacific and General's request is for an advisory opinion.

C. There is little likelihood that there ever will be a tax controversy.

D. If there ever is a tax controversy, the parties to the controversy would be the taxpayers American Telephone and Telegraph and General Telephone and Electronics (AT&T and GT&E), and the Internal Revenue Service (IRS). None of these parties was a party in the PUC or California Supreme Court proceedings or are they parties in this proceeding.

E. The positions of the parties in any future dispute are unknown as positions for rate purposes could differ from positions for tax purposes.

F. The statutory language in the Internal Revenue Code is so clear that the tax issue raised is not substantial.

II. The PUC Decision Has Only a Narrow Intrastate Impact Not Worthy of Review.

A. The refund and reductions will merely slightly reduce petitioners' windfall profits without adverse impact.

B. PUC decisions have no binding impact on any other state or federal regulator's jurisdiction.

ARGUMENT

The Cities are in accord with the "Brief in Opposition" of the PUC on the issues of "Supremacy Clause" and "Fourteenth Amendment" and will not further address these issues. This brief will discuss General's request for what amounts to an advisory opinion on tax eligibility and indicate that the PUC decision is

limited to intrastate rate making with no national impact. This analysis will demonstrate that there is no basis to grant the petitions.

I. Tax Eligibility Advisory Opinion.

General asks the Court to issue an advisory opinion on the question of eligibility for JDIC and accelerated depreciation under Sections 46(f) and 167(l) of the Internal Revenue Code. The Court should refuse to entertain jurisdiction over this issue.

A. Adequate Grounds Below Independent of Tax Eligibility

The California Supreme Court denied the petitions for writ of review without opinion. (P.App. A, pp 1A, 2A) Before the California Court, Pacific stated that the primary question was, "whether the rate making methods adopted by the California Public Utilities Commission in Decision No. 87838 are consistent with the eligibility requirements of federal law." (Page 1, letter to California Supreme Court, dated June 9, 1978.) PUC and Cities argued the merits of the eligibility issue and also argued that the PUC's order should be sustained *without regard to income tax eligibility.*

The PUC in its letter to the California Court dated June 22, 1978, stated, "Moreover, as the Commission pointed out in its answer, the prime issue is actually that of the lawfulness of the Commission's decision as an exercise of its mandated authority under the California Constitution and the Public Utilities Code." (R.App. B, p 62RA) The Cities' arguments on this point appeared in its Answer and in Cities' letters to the Court of June 26, 1978, and July 5, 1978. (R.App. B, pp 53RA-60RA, 65RA-69RA)

The Cities contended that the PUC adopted a rate making method consistent with the intrastate rate

making criteria promulgated in the California Constitution and Public Utility Code and explained in *San Francisco* and *Los Angeles II*.

The California Supreme Court, in *San Francisco*, unanimously held that the PUC could choose a rate making method "notwithstanding the change in the federal tax statute," and "even assuming the absence of the option" to use accelerated depreciation. (R.App. A, pp 11RA, 14RA) The Court reached this conclusion based on its conclusion of law regarding the PUC's power to enact intrastate rate making adjustments based on its findings of fact that management had imprudently incurred excessive tax expenses.[8] The Court stated,

> Under its general power to prevent a utility from passing on to its ratepayers unreasonable costs, the commission in the instant proceeding, notwithstanding the change in the federal tax statute, could properly find that the federal income tax calculated on the basis of straight line depreciation involved an unreasonable expense and that the unreasonable expense due to such calculation was due to an imprudent management decision.
>
> Although prior to its statutory change, Pacific was free to change its method of accounting on its income tax returns but now may no longer do so, its inability to switch is due to its original imprudent determination to pay federal income taxes on a straight line depreciation basis and its obstinancy after the 1968 Commission decision in adhering to the imprudent determination. (R.App. A, pp 11 RA-12RA).

The California Supreme Court concluded that because flowthrough was a valid intrastate rate making

8. This Court has recognized that findings of incursion of "wasteful or negligent losses" or "inefficiency or improvidence" justify rate adjustments. *West Ohio Gas Co. v. Public Utilities Com.* 294 U.S. 63, 68, 72 (1935).

practice the PUC could adopt alternative approaches less harsh than flowthrough. (*San Francisco* at R.App. A, pp 15RA-16RA). In *Los Angeles II* the Court held that the annual adjustment method, similar to that adopted in the instant case, was a permissible rate setting alternative. (R.App. A, pp 33RA-46RA). The rate making method finally adopted by the PUC is consistent with the holding of the California Supreme Court in *Los Angeles II*, remanding the issue to the PUC with instructions.

These independent grounds raised before the California Supreme Court were adequate to support the California Court's decision irrespective of the tax eligibility issue. Under these circumstances, the Court should presume that the California Supreme Court decision was based upon these independent grounds raised below.

B. No Present Controversy

There is no present tax controversy. Petitioners' parents, AT&T and GT&E, use accelerated depreciation. IRS audits have not challenged past use of these tax options or restricted future use.

C. Uncertainty of Future Controversy

Pacific has raised the spectre of ineligibility at various times in the past and has been *proven* clearly wrong. In *Pacific Telephone* v. *City of Los Angeles*, an Application for a stay of the California Supreme Court's refund order in *Los Angeles I*, filed in the United States Supreme Court, No. A69, dated July 13, 1972, Pacific claimed, at page 19,

> "Under the Court's order the Commission is required to reinstate the 1968 rates. These rates are on the basis of accelerated depreciation with flowthrough. In this situation the Internal Revenue Service undoubtedly will assert that under the Tax

> Reform Act of 1969 petitioner must compute and pay its federal income taxes for this period on the basis of straight line depreciation. Thus petitioner can be required to pay millions of dollars in taxes, no part of which it will be able to recover in rates."

Justice White and Justice Rehnquist each denied Pacific's application on July 28, 1972.

Pacific's rates were then reset by the PUC on the basis of flowthrough. *IRS audits* confirmed Pacific's eligibility for accelerated depreciation and JDIC despite the use by the PUC of flowthrough for rate purposes. In the period 1970-1973 Pacific kept its books on the basis of normalization and had its rates set on the basis of full flowthrough. Despite its predictions of ineligibility to this Court, Pacific continued to use accelerated depreciation and JDIC. The IRS has audited Pacific's books for 1970-1973 and has not made any assessment because of Pacific's JDIC or accelerated depreciation practices.

In arguments before the California Supreme Court in the 1978 case (SF No. 23746), Pacific alleged that it faced retroactive ineligibility dating back to 1970.[9] This claim has proven to be erroneous with respect to the years 1970-1973. The 1970 IRS audit was complete *prior* to the filing of Pacific's California petition. While the issue was before the California Supreme Court the IRS completed its 1971-1973 audit without questioning eligibility. Although Pacific on June 9, 1978, informed the Court of a letter from a Geoffrey Taylor of the IRS related to accelerated depreciation (P.App. D), Pacific never informed the California Court of the results of the IRS audit.[10]

9. Pacific's claimed federal income tax liability was presented by Pacific on pages 71 through 73 of its Appendix to its petition to the California Supreme Court in S.F. No. 23746. It appears in R.App. D, pp 75-77.

10. Pacific only claims retroactive problems from 1974 in 78-606 (Pacific Pet. p 21 fn. 31, 22).

Claims of ineligibility made to the United States Supreme Court and the California Supreme Court have been erroneous. The IRS had not challenged Pacific's taxes. It cannot be assumed that the IRS will ever challenge Pacific's eligibility.

D. Absence of Parties

If the eligibility to use accelerated depreciation is ever challenged, the parties to that controversy will be the IRS and the taxpayers, American Telephone and Telegraph (AT&T), General Telephone and Electronics (GT&E), the parents of the petitioners. The parent corporations file consolidated income tax returns. They, not the subsidiaries, are the taxpayers. The parents and the IRS are not parties in the instant proceeding.

E. Uncertain Position of Parties in Event of Tax Controversy.

In the unlikely event that there is a tax controversy over eligibility, the positions of the parties will be developed. Positions in an actual controversy could differ from positions in instant case.

Utilities' Position

For *rate* purposes and purposes of this litigation petitioners claim they will be ineligible to use accelerated depreciation and JDIC. This is a tactical decision. For *tax* purposes, their positions could be considerably different. In 1972, Pacific told this Court it would be ineligible to use accelerated depreciation. It then filed its income taxes on the grounds that it was eligible.

In candid comments to the press a Pacific executive claimed,

> "We will probably fight in tax court against paying those taxes. And to do so we will have to take the exact opposite side of the argument. We will have to maintain that we have been wrong and the Commission right during all these years of disagreement and litigation." (A. C. Latno, Executive

Vice-President, Pacific, quoted on page 1 of the San Francisco Recorder, September 25, 1978.)

Pacific's Treasurer, in testimony to the PUC agreed that there was a possibility that Pacific would in fact challenge any tax assessment on the basis of the arguments the PUC had raised (PT&T A. 58223, R.T. 1539-1540).

Pacific's and General's arguments are simply arguments of convenience for rate purposes. Under these circumstances, it would be beyond the Court's jurisdiction to issue any advisory interpretation of the Internal Revenue Code.

Position of the IRS.

Pacific and General both cite the issuance of Taylor and Holt letters (P.App. D and E) which purportedly uphold their view of ineligibility. General states at page 17 with regard to the IRS letters, "There is no sound basis for questioning its judgment."

These letters should be viewed in perspective. The letters from IRS employees Taylor and Holt (P.App. D and E) responded to specific requests from Pacific and General. Essentially, the petitioners requested that the IRS find them *ineligible* for the use of accelerated depreciation. Pacific's September 29, 1977, letter to the IRS stated at page 6,

> "*Statement of Position.* Although Pacific obviously desires to retain its eligibility for accelerated depreciation, ADR, the class life system and the investment credit, it believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in good faith seek rulings that the Decision is consistent with those requirements."

General also failed to make a single argument on behalf of eligibility. Under these circumstances, it was

inevitable for Taylor and Holt to send letters such as appear in P.App. D and E.

After issuance of the Taylor letter on June 8, 1978, the IRS still could have made further assessments in its audit of AT&T for the years 1971 through 1973. In the alternative, it could have asked AT&T to extend the period of limitations on assessments beyond June 30, 1978. The IRS did neither. The IRS should be judged on its *actions* in enforcing the tax law and not on a letter of Geoffrey Taylor. This point is reinforced by analyzing another Taylor letter.

On January 11, 1977, Mr. Taylor wrote the New Mexico Public Service Commission that eligibility for JDIC would be lost unless "in determining the overall cost of capital of a utility for rate making purposes, deferred investment tax credits are properly to be included and assigned a rate not less than that considered applicable to common equity." (R.App. D, p 80RA) Mr. Taylor claimed his opinion was "a well-established interpretation of tax law." (p 79RA)

Mr. Taylor's interpretation of the JDIC eligibility provisions, which were in effect since 1971, was novel. For rate purposes, Pacific's capital structure has never been based on this method. Pacific admits that the methods it has employed and advocated in the past have been inconsistent with the Taylor methodology. (CPUC, A58223, Joses R.T. 1212, 1217) To our knowledge, no utility's rates were set on this method prior to 1977.

Despite the fact that Pacific's and all Bell systems' rates were not set in conformity with the method described by Mr. Taylor, the IRS did not challenge the treatment of JDIC by any AT&T affiliate in the 1971-1973 audit, an audit completed over one year after the Taylor letter.

The Taylor letter itself is clearly wrong in inter-

pretation and not enforced by the IRS. The Federal Energy Regulatory Commission, in Carolina Power and Light, Docket No. ER76-495 (Phase II), Opinion 19, August 2, 1978, printed in 15 Federal Power Service 5-619, reviewed Mr. Taylor's letter. It concluded at 5-624:

> "First, on the matter of the IRS information letter, it is our opinion that the statements made therein do not represent a correct interpretation of the requirement of Section 46f."

Any speculation on the IRS position should be based upon what the IRS does, and not upon what Mr. Taylor says. The IRS has wisely failed to follow Mr. Taylor's interpretation of the tax law in its audits of Pacific.

F. Unequivocal Statutory Language.

The answers to the eligibility question raised by General are clear from the statutory language.

Accelerated depreciation

General argues that eligibility for accelerated depreciation will be lost because of an "excessive exclusion from rate base." (Pet. 78-607, p. 12) Pacific cites three prerequisites to the use of normalization for tax purposes. The third one is, "The regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of the cost of service." (Pet. 78-606, p. 6) There is no basis in the Code, implicit or explicit, for these claims. Pacific and General never cite statutory language in support of their claimed ineligibility.

A company that failed to use accelerated depreciation prior to July of 1969 may use accelerated depreciation if it "uses a normalization method of accounting." IRS (Sec. 167(l)(2)(B). (P.App. C, p 80A) This section is applicable to General and Pacific since they

failed to elect accelerated depreciation in the earlier period.

Normalization is defined by statute in Internal Revenue Code Section 167(l)(3)(G) (P.App. C, pp 84A-85A). The statutory definition neither explicitly or implicitly restricts the rate base treatment of the normalization reserve as a condition of eligibility. Congress left no doubt that it was not restricting, in any way, the *rate base* treatment of the deferred taxes reserve.

> "Where normalization is used, this bill in no way diminishes whatever power the agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated." (House Report 91-413, 91st Congress, First Session 1969 at page 133.)

> "The bill does not change the power of the regulatory agency in the case of normalization to exclude the normalized tax reduction on the base upon which the agency computes the company's maximum permitted profits." (Senate Report 91-52, 91st Congress, First Session 1969 at page 173.)

The method of rate base treatment is not relevant to a determination of normalization.

The PUC, in Decision No. 87838 adopted the normalization method of accounting. It *then* made a deduction from rate base of the normalization reserve in conformity with California law.

In California, rates are set as nearly as possible to be representative of future conditions. *Los Angeles I*, 7 Cal.3d at 346. A calendar test year treatment of the normalization reserve would enable Pacific to earn excessive profits above those anticipated for a normalization company. This was explained by the California Supreme Court in *Los Angeles II*. (R.App. A, p 31RA);

"The Commission's staff experts testified that the rapidly accumulating tax reserves presented an anomalous factor in the telephone companies' financial profile similar to that posed by the fuel costs of the power companies.

The Commission accepted this analysis, explaining that: "One consequence of the use of accelerated depreciation by Pacific is to create a rapidly growing reserve for deferred taxes that is totally out of consonance with the roughly harmonious relationship between revenues, expenses, and rate base."

These facts led the Commission to use a four-year average to determine tax expense and rate base deduction. The PUC explains its methods at pages 22A-28A and findings 3 and 5 (pp. 45A-46A at P.App. B.) The PUC clearly had the authority to make such an intrastate rate making adjustment. The Internal Revenue Code contains no restrictions on this method of intrastate rate making.

JDIC.

In regard to JDIC, General and Pacific have elected to use the ratable flowthrough method. The Code specifically provides only two circumstances under which eligibility can be lost. One is a 'cost of service reduction' in excess of ratable flowthrough. The second is a rate base reduction. (IRC Sec 46(f)(2), P.App. C, p 76A)

The Commission has set rates in strict conformity with these statutory requirements. A cost of service reduction is strictly based on ratable flowthrough and no rate base reduction occurs at any time. The method is fully described and approved by the California Supreme Court in *Los Angeles II.* (R.App. A, pp 33RA-46RA)

G. Conclusion—Tax Eligibility

The Court should not issue an advisory opinion on

the issue of eligibility. There is no present or even anticipated future tax controversy. Parties to any future controversy are not before this Court or in the proceedings below. The positions of litigants in this speculative future controversy are unknown. Eligibility will be retained under the clear language of the statutes. Pacific and General have only raised these issues as a regulatory tactic to gain excessive rates.

II. Limited Impact of Intrastate Rate Order.

In an attempt to gain certiorari, the telephone companies exaggerate the potential impact of the PUC decision. On pages 28 through 31, Pacific's petition paints a picture of gloom and doom if it is compelled to make refunds and rate reductions. These arguments are not new. In applying to the United States Supreme Court for a stay of the California Supreme Court's order in *Los Angeles I*, Pacific told this court, in No. A69, *Pacific Telephone* v. *City of Los Angeles*, "The amount involved is so large as to have a serious effect on the petitioner's financial condition and its ability to serve the public." (Page 19 fn. 27.) Pacific also argued to the PUC that if it ever adopted flowthrough the result would be "degradation of service and possible financial collapse" and that utilities would "go bankrupt." (*Los Angeles II* (R.App. A, p 26RA)

Justices White and Rehnquist denied Pacific's application for a stay of the California Supreme Court's order on July 28, 1972. The PUC then reset rates on the basis of flowthrough. As a result of these orders, Pacific refunded over $176,000,000 and reduced Pacific's rates by approximately $90,000,000 per year.

The PUC states in Decision 87838 that this refund and reduction resulted in no significant employee layoffs, no deterioration in service and no adverse effects on earnings. (P.App. B, p. 35A, 36A) Based on this

successful experience *Pacific* told the California Supreme Court that it was "financially capable of any . . . refunds" in the instant case. (Pacific Memo to California Supreme Court, August 16, 1974)

Now that refunds are at hand, Pacific takes the opposite tack and claims that such refunds and rate reductions "will have a destructive impact on Pacific's financial integrity." (Pac.Pet., p 28) Pacific's claim is baseless, disproven in the past, and is in contradiction of Pacific's claim to the California Supreme Court that it was financially capable of making any refunds.

Both Pacific and General argue that California's intrastate rate making treatment will have a significant national impact. At Pages 24 through 25 Pacific argues that "regulatory agencies throughout the country" may well take similar action. General argued, at page 19, "Regulators in other states must pay attention," and goes on to state that "every General telephone company and every telephone company in the Bell System is vulnerable." These arguments are without merit.

The PUC order is an *intrastate* rate decision based on specific findings of managerial imprudence. Neither the PUC nor the California Supreme Court can direct the policy of any other regulatory body. In the event any other jurisdiction attempted to adopt the California rate making methodology, AT&T and GT&E affiliates would strenuously argue against the applicability of the California method.

The California Supreme Court has made it clear that the methodology that was adopted by the PUC is not even binding on the PUC in future rate cases. (*Los Angeles II*, (R.App. A, fn. 42 pp 46RA, 47RA) We are left with a rate making method that has finally been approved by the California Supreme Court which is applicable to these companies at this point in time. The

case itself has taken a long time to resolve simply because the PUC, following Pacific's advice, refused to comply with the mandates of the California Supreme Court. An order has finally been issued by the PUC which complies with the California Supreme Court's mandate. The order has a minor transitory intrastate rate making impact. The issue is unworthy of Supreme Court review.

CONCLUSION

Petitioners have offered this Court no basis to grant their Petitions. The Petitions under consideration herein should be denied.

Respectfully submitted,

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1978

Nos. 78-606 and 78-607

The Pacific Telephone and Telegraph Company,
Petitioner,

v.

The Public Utilities Commission of the State of California, Et Al.,
Respondents.

General Telephone Company of California,
Petitioner,

v.

The Public Utilities Commission of the State of California, Et Al.,
Respondents.

BRIEF OF RESPONDENT TOWARD UTILITY RATE NORMALIZATION (TURN) IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

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INTEREST OF TURN

TURN is a non-profit corporation organized under the laws of the State of California. It functions to represent the interests of residential consumers generally, as well as specific consumer organizations and constituencies. TURN participated in the proceedings leading up to the California Commission Decision and the proceedings of the California Supreme Court affirming the Commission Decision.

QUESTIONS PRESENTED

(1) Whether petitioners are properly before this Court where they (1) seek an advisory opinion on (2) State ratemaking issues which are supported on independent State grounds.

(2) Whether the federal tax statutes and/or IRS regulations that create permanent tax savings unlawfully dictate to a state regulatory commission the precise regulatory treatment that must be accorded the tax savings, in light of the Tenth Amendment to the United States Constitution.

STATEMENT

This appeal raises the question of how the tax benefits associated with accelerated depreciation and

the investment tax credit (ITC) should be treated for the purposes of intra-state utility ratemaking. In the state of California it has been ascertained that such tax benefits result in permanent tax savings as a matter of empirical evidence and as a matter of State law.[1]

For the period covered by the present proceeding (1970-1977) Pacific Telephone & Telegraph Company (Pacific) had accumulated tax savings of $925,000,000[2] and General Telephone Company (General) had accumulated tax savings of $265,000,000. The Commission Decision here on review ordered Pacific to refund to its customers $161 million of the tax savings and General to refund $55 million.[3] Those tax savings not refunded to customers were retained by the utilities as a ratepayer contribution to capital, contrary to normal regulatory principles.[4] The Commission also ordered ongoing rate reductions of $55 million for Pacific and $11 million for General to

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[1] See pages 7-14.

[2] This figure is taken from Pacific's Petition to the California Supreme Court, Appendix, pp. 71 & 73.

[3] These figures are for the years 1970-1977. Pre-1970 utility property and consequent tax savings are deleted because the federal tax statutes do not address these prior years.

[4] It is universal regulatory law and a basic tenet

reflect ongoing tax savings of the utilities. These sums also represent a small fraction of the actual tax savings of the utilities and represent a further ratepayer contribution to capital for any corporate purpose the companies choose.

These tax savings result from the use of normalization accounting for ratemaking purposes by both Pacific and General. Normalization accounting involves calculating federal taxes actually paid to IRS using accelerated depreciation while using straight line depreciation in calculating taxes for intrastate ratemaking purposes. Accelerated depreciation results in higher deductions and thus lower actual taxes paid to IRS. At the same time, straight line depreciation results in lower deductions and thus artificially inflated tax expense for ratemaking purposes. The end result of this accounting scenario is the charging of higher phantom tax expense to ratepayers based on straight line depreciation while the actual payment of lower taxes to IRS is calculated using accelerated depreciation. The difference

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of capitalism that investors fund capital expansion, not ratepayers, who are captive customers of monopoly enterprises. See San Francisco v. PUC (1971) 6 C 3d, 119, 128, 98 CR 286; also Decision No. 87838, pp. 43A - 44A (The page numbers refer to the Joint Appendix filed by General and Pacific).

between the two tax figures (phantom tax) is the actual tax savings which is accounted for in a deferred tax reserve.[5] The phantom taxes reflected in the deferred tax reserve have already been collected from utility ratepayers by the utility. The disposition of these phantom taxes forms the backdrop to the present proceeding.[6]

Pacific and General seek by their petitions to have the entirety of the phantom taxes collected by the utilities from ratepayers, but never paid to IRS, retained solely for their own unrestrained use.

The Commission recognized that the tax benefits associated with accelerated depreciation and ITC resulted in permenent tax savings,[7] and that flow through accounting was the best method of handling these tax benefit savings.[8] However, it adopted a normalization accounting procedure which returned only a small percentage of the

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[5] IRC section 167(l)(3)(G)

[6] The reason phantom taxes are created is that the utility collects taxes from its ratepayers that are never paid to IRS. The deferred tax reserve constitutes this phantom tax.

[7] Findings 16 and 19, p. 48A.

[8] Finding 2, p. 45A.

phantom taxes to the utility customers. The basic error of the Decision is the Commission's failure to return all of the phantom taxes to the ratepayer, not in returning only a small portion.[9] This view differs from the companies' assertions that <u>any</u> return of tax savings is in error.

Both General and Pacific misstate the relevant legal issues before the Court. What is involved is the use of regulatory principles in regard to an intrastate ratemaking matter. What is not involved is whether or not the particular regulatory treatment of taxes adopted by the California Commission is in accord with federal tax legislation and/or federal tax regulations.[10] The reason for this is that the federal laws involved here do not compel a state commission to use any particular method of treating federal income tax expense. What the Commission has done in the present case, and what

[9]TURN has until December 26, 1978 in which to file a Petition with this Court since we sought rehearing of the California Supreme Court decision.

[10]Although the Commission has stated a desire to preserve eligiblity, and has, in fact, calculated rates in accord with the requirements of eligibility, the Commission did not premise the Decision on eligibility being maintained. The Commission perhaps anticipated that eligibility to a great extent was in the hands of General and Pacific. See Decision No. 88215, Pacific Tel (1977) -Cal PUC-, which indicates the Commission's willingness to adopt flow through accounting if the Decision does result in ineligibility.

the California Supreme Court has affirmed, is to apply State regulatory ratemaking principles in regard to the tax expense issue. In this regard it is important to emphasize that in rendering its decision the Commission had before it three prior California Supreme Court decisions that enunciated the principles which were to govern the present proceeding. None of the Supreme Court decisions were appealed to this Court, even though these three decisions overturned Commission orders which adopted Pacific and General's version of normalization accounting. Furthermore, the Commission had before it three of its own prior decisions (aside from those overturned by the California Supreme Court) which enunciated ratemaking rules applicable to General and Pacific. These three Commission decisions similarly were not overturned by any higher judicial authority.

PRIOR COMMISSION DECISIONS

As early as 1960, the California Public Utilities Commission first had occasion to investigate the regulatory rate fixing treatment to be accorded accelerated depreciation in relation to section 167 of the federal tax code. In a case entitled <u>Rate Fixing Treatment for Accelerated Amortization and Depreciation</u>

of All Utilities (1960) 57 Cal PUC 598, the California Commission relied on two United States Supreme Court cases, Galveston Electric Co. v. City of Galveston, 258 U.S. 388, and Georgia Railway v. Railroad Commission, 262 U.S. 635, in concluding that

> "the ratepayers of a public utility could (not) be required, in any event, to bear the burden of ... more income taxes (than) were actually paid by the utility." 57 Cal PUC at 600-601 (emphasis added).

The Commission similarly concluded that the use of accelerated depreciation by a regulated utility results in permanent tax savings, stating:

> "The record in this proceeding is clear that public utilities, for the foreseeable future, will continue to construct new plant to an extent which will be sufficient to more than overcome retirements to such plant.[11] In such circumstances, the theory of normalization, based upon the concept of a deferred tax liability, would not have an opportunity to operate . . .
> "Based upon the record in this case, we find that, as applied to Section 167, there is created no income tax deferral and no deferred tax liability. The operation of said section provides a vehicle and a procedure whereby the taxpayer may reduce his taxes just as though the tax rate had been reduced. So far as tax liability may be concerned, the end result would be the same in each case. Should this Commission adopt the so-called normalization theory, we would be required to close our eyes to the obvious facts of the future which can reasonably be expected to result from California's tremendous economic growth. There is no duty incumbent upon this Commission to adopt a theory which is at war with the facts of experience and the reasonable expectations for the future." 57 Cal PUC 599, 600 (emphasis added).

[11] This finding was repeated in Pacific Telephone & Telegraph (1968) 69 Cal PUC 53, 61-63 and was affirmed as a matter of law in City & County of San Francisco v. PUC (1971) 6 C 3d, 119, 123, 98 CR 292; City of Los Angeles v. PUC (1975) 15 C 3d, 680, 686, 125 CR 779. See also Alabama-Tennessee Natural Gas Co. v. FPC (1966) 359 F 2d 318, 328, 366, cert den. 355 U.S. 847; Midwestern Gas Transmission v. FPC (1968) 388 F 2d 444, 447.

It is uncontested in the present proceeding that both General and Pacific "will continue to construct new plants to an extent which will be sufficient to more than overcome retirements to such plants." After the above decision, all major utilities in California with the glaring exception of General and Pacific elected to reduce taxes by taking accelerated depreciation and flow through the tax savings to their customers. In subsequent years, the Commission dealt with the refusal of General and Pacific to take advantage of accelerated depreciation, reasoning that

> "The establishment of public utility charges involves the assessment of all reasonable costs for a public service, including taxes . . . Generally, when management judgments produce results which are unfair to the ratepayer, regulation steps in. Pacific's management, reflecting the general Bell System policy, has seen fit to choose that method of computing income taxes which results in maximum tax costs and, hence, maximum charges to its ratepayers . . . A utility is a

collector of taxes from its patrons and even its costs of collection are borne by them; its 'payment' of taxes, in the final analysis, costs it nothing. Management's discretion has exceeded a reasonable and prudent course respecting income taxes, to the detriment of the public interest. For the rate-making purposes of this proceeding, therefore, we shall compute Pacific's income tax expense for the test year 1967 as though Pacific had taken the favorable option for which the law provides. Protection of the public interest demands such procedure." Pacific Tel. & Tel. (1968) 69 Cal PUC 53, 62-63.

Similarly, the Commission made ratemaking adjustments in regard to General in the following terms:

"General has not acted in a reasonable and prudent manner, all to the detriment of the public. It is reasonable to compute General's income tax expense for the test year on the basis of the use of accelerated depreciation beginning with plant addition in such year." General Tel. 69 Cal PUC 690 (1969).

General did not seek judicial review of the decision. As a result of these two decisions, General and Pacific, for ratemaking purposes, had their taxes computed on the basis of imputed accelerated depreciation and flow through.

The reason for the formal finding of imprudence was that Pacific and General, alone among major California utilities, persisted in using straight line depreciation when accelerated depreciation was available to them. Had the two imprudent utilities opted for accelerated depreciation, they would have saved themselves

and their customers millions of dollars in tax expense.[12] At any rate, the California Commission finally imposed regulatory restraints on General and Pacific by imputing accelerated depreciation in calculating taxes for ratemaking purposes. To this very day the Commission recognizes that "Pacific and General were imprudent in failing to select accelerated depreciation when that option was available under the federal tax laws." Decision No. 87838, finding 1, (45A).

Thus, California regulatory law had crystallized in regard to the regulatory treatment to be accorded federal tax benefits. The California Commission recognized that the use of accelerated depreciation resulted in permenent tax savings (and not a deferral) and that a utility had the affirmative obligation to use those tax accounting methods that resulted in the lowest tax expense. In recognition of these regulatory principles, the Commission passed along to utility customers the tax savings resulting from the use of accelerated depreciation. In those situations

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[12]The Commission found that between 1954-1967 Pacific could have reduced taxes $225,000,000 and thus reduced rates charged to their customers by $450,000,000. Taxes are collected from ratepayers on a 2 for 1 basis. $2 of ratepayer funds are required for $1 in taxes. Pacific Tel. & Tel. (1968), supra, at 61-63.

wherein the utility obstinately refused to opt for the benefits of accelerated depreciation, the Commission imputed the use of accelerated depreciation in calculating ratemaking expenses. This was the well established State of California regulatory law at the end of 1969.

TAX REFORM ACT

In 1969 Congress passed the Tax Reform Act to be effective starting in 1970. This act provided that utilities who had previously used straight line depreciation in computing taxes, including General and Pacific, could switch to accelerated depreciation only if they used straight line depreciation in computing tax expense for ratemaking purposes.[13] This practice, known as normalization, resulted in the utilities charging their customers higher taxes than were paid to IRS and retaining these funds for unrestricted use.[14] General and Pacific reversed their longstanding

[13]IRC 167(l)(2)(B)

[14]Although there may be legitimate reasons for using tax laws to encourage private business investment in plant and equipment, public utilities are required as a matter of law to expand plant and equipment in order to provide adequate service. A utility is provided funds from ratepayers for this purpose and is allowed a return on their investment. If anything, unregulated capital expansion will result in unneeded plant and equipment which will be disallowed in rate base. See City of Pittsburgh v. Penn. PUC (1957) 17 PUR 3d 249.

refusal to take advantage of the tax benefits, and elected to opt for accelerated depreciation starting in 1970. The obvious reason for this change of position was the recognition by General and Pacific that they might now be able to keep all the tax savings to themselves while charging their customers a higher non-existent tax. All other California utilities are eligible to use accelerated depreciation for tax purposes with flow through of the tax savings to the utility customer. It is only because of the imprudence of Pacific and General in first refusing to elect accelerated depreciation and their continued obstinacy in refusing to change after being cited for their imprudent conduct, that they cannot now use accelerated depreciation with flow through.

CALIFORNIA SUPREME COURT DECISIONS

After the passage of the Tax Reform Act (TRA), the Commission in a series of decisions[15] sought to annul its prior practice of flowing through to utility customers the benefits of accelerated depreciation

[15]Pacific Tel. & Tel. (1970) 71 Cal PUC 590; General Tel. (1970) 71 Cal PUC 657; General Tel. (1971) 72 Cal PUC 652/92 PUR 3d 224; Pacific Tel. & Tel. (1974) 77 Cal PUC 117; General Tel. (1974) 77 Cal PUC 558; General Tel. (1974) 77 Cal PUC 590.

and the investment tax credit (ITC).[16] The rationale given by the Commission for its abandonment of well established regulatory principles was that the federal tax statutes mandat d that the Commission retain the entirety of the tax savings associated with accelerated depreciation and the investment tax credit.

In a series of three unanimous decisions, the California Supreme Court reversed the above decisions of the Commission, holding that the Commission failed to consider lawful alternatives in dealing with the tax expense issue. City & County of San Francisco v. PUC (1971) 6 C 3d 119, 130, 98 CR 292; City of Los Angeles v. PUC (1972) 7 C 3d 331, 102 CR 313; City of Los Angeles v. PUC (1975) 15 C 3d 680, 125 CR 779.

In its 1971 decision the California Supreme Court noted that where a utility uses accelerated depreciation for actual tax-paying purposes, but adopts straight line depreciation for ratemaking purposes (normalization), it "deliberately overstates the actual tax expense." (6 C 3d at page 130.) The Court noted that the Commission could disallow accounting practices such as normalization, which result in unreasonably inflated tax expense. The

[16]The ITC first became available in 1971.

decision found that accelerated depreciation resulted in permanent tax savings and not a tax deferral, that requiring ratepayers to pay in rates an amount in excess of actual taxes resulted in a ratepayer contribution to capital, and that based on the imprudence of Pacific in not electing accelerated depreciation prior to the TRA and its continued obstinacy in refusing to opt for that alternative after being cited for imprudence, the Commission could legally continue to apply its traditional accounting practices in regard to the tax expense issue. The Court recognized that normalization results in "fictitious allowances for tax expense." (6 C 3d at 130.) The Supreme Court suggested the Commission could adopt a compromise between full flow through and normalization. Even though the decision annulled a Commission decision ordering normalization, Pacific did not appeal the decision further.

The 1972 decision annulled a Commission decision which was rendered prior to the 1971 Court decision. To prevent these rates from becoming final on the issue of tax expense the Court annulled the decision. This decision also was not appealed. The 1975 California decision held that:

"Ratemakers have discovered that if the total enterprise is either expanding or stable, the use of accelerated depreciation does not merely defer taxes, but eliminates them entirely . . . The result is a net tax savings to any utility using accelerated depreciation." (Emphasis in original) 15 C 3d at page 686.

Based on this the Court concluded:

"If the Public Utilities Commission in setting rates were to assume that tax deduction for depreciation under both the straight line and accelerated method would yield the same result in the long run, it would, in fact, award the utility a rate windfall. For it would have set rates as if the utility would incur tax expenses which it would never have to pay." Id. at 689.

The Court again reversed the Commission, ordering it to consider all lawful alternatives, noting that it could forthwith adopt an annual adjustment formula offered by the Commission staff. The annual adjustment formula of the staff, termed "pro forma normalization," is very similar in concept to the formula adopted by the California Commission in the present proceeding. Despite the fact that the 1975 decision again reversed a Commission decision that would have ordered full normalization and even recommended the adoption of a formula very similar to the one here on review, neither Pacific or General sought further review of the Court decision.

THE COMMISSION DECISION

The Commission rendered Decision No. 87838 on

September 13, 1977. It sought to render a decision which would comport with regulatory principles and at the same time be in accord with the federal tax regulations. As a result of said Decision the Commission ordered Pacific to refund to ratepayers $160 million of $430 million of past collected phantom taxes and ordered a reduction of $55 million of $240 million in present rates charged to ratepayers. General was ordered to refund $55 million of $122 million of past collected phantom taxes and ordered a reduction of $11 million of $55 million in present rates charged to their ratepayers. The end result of the Commission decision is that Pacific was allowed to retain $270 million in tax expense that will never be paid to Internal Revenue in actual taxes. For General the comparable figure is a $67 million retention of phantom taxes. In setting present rates, the Commission allowed Pacific to charge to ratepayers $185 million in phantom tax expense that will be collected from ratepayers but never paid to IRS in actual taxes. The comparable figure for General is $44 million. The end result of this scenario is that the two utilities get a windfall of a total of $337 million in back collected phantom tax expense and an ongoing annual rate increase of $229 million in phantom tax expense that will be

collected from ratepayers but never paid to IRS.

In its decision, the Commission adopted a formula called average annual adjustment. This formula holds all cost-of-service items constant for the test year except for the calculation of the sums in the tax reserve account. Because the amounts accruing in the tax reserve vary abnormally with respect to other utility expenses, the Commission chose to average the test year tax reserve expenses plus the succeeding three years. This methodoloty is consistent with regulatory principles and has been approved by the California Supreme Court. City of Los Angeles v. PUC (1972) 7 C 3d 331, 347; Pacific Tel. & Tel. v. PUC (1965) 62 C 2d 634, 645.

In regard to the investment tax credit, the Commission adopted a formula which adjusted the test year ITC every year based on the best estimate of the forthcoming ITC for the calendar year, again based on the fact that ITC varies abnormally in comparison with other utility expenses.

Despite the windfall profits awarded General and Pacific by the Commission, the utilities persist in thinking that somehow and in some manner they have been treated unfairly. There is no merit to their position. The California Supreme Court in its 1971 decision made it clear that the Commission had the authority irrespective

of the federal tax regulations to imput accelerated depreciation with flow through to the telephone telephone utilities. (6 C 3d 119, 130.) As already noted the 1971 decision annulled a rate order which would have ordered full normalization of the federal tax benefits. This decision was not appealed. Thus, to the extent that Pacific and General are allowed to retain any of the phantom taxes they have no cause to complain. Of course, in the present case they have been allowed to retain an overwhelming majority of the phantom taxes, approximately two-thirds of the reserve funds.

PROCEEDINGS AFTER THE COMMISSION DECISION

Having failed to win approval of their one-sided interpretation of the federal tax laws either before the California Commission or the California Supreme Court, Pacific and General now for the first time turned their sights on Internal Revenue as a potential ally in their attempts to impose their one-sided views on the California Supreme Court, the regulatory commission and the ratepayers. In doing so, Pacific specifically sought to have itself declared ineligible for the federal tax benefits and make itself liable for more than $1 billion in back benefits. Pacific's

letter to Internal Revenue specifically states that:

> "It believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in good faith seek rulings that the Decision is consistent with those requirements." (Pacific letter to IRS, page 6, dated September 29, 1977.)

General sent a similar letter to IRS, also seeking to have itself declared ineligible for federal tax benefits. Pacific and General then requested the Commission to join with them in the proceedings before IRS. The Commission refused, noting that the Commission seeks to preserve eligibility while the utilities seek ineligibility. Furthermore, there is an obvious confluence of interest between the utilites seeking ineligibility and IRS obtaining over $1 billion in back taxes as a result of ineligibility. All that is needed to accomplish the common objective is to locate employees of IRS who would be willing to render a ruling. This was accomplished and Pacific and General were successful in getting IRS to agree that indeed Pacific and General would be ineligible for federal tax benefits if the Commission decision was implemented. The IRS advisory rulings in regard to accelerated depreciation were submitted to the California Supreme Court by the two utilities. With these rulings before it, the California Supreme Court affirmed

the decision of the California Commission without opinion.

REASONS FOR DENYING WRITS

I. The Final Decision of The California Public Utilities Commission is Not Reviewable by This Court Since It Was Based On An Adequate State Ground.

This Court lacks the power to overrule decisions of state tribunals which are governed by interpretations of State Law (Herb v. Pitearin (1945) 34 U.S. 117). Even if a Federal question is raised by a given controversy, this Court has no jurisdiction to review the matter if that Federal question can be avoided. The Federal question can be avoided when there are adequate independent state grounds to support the decision of the state tribunal (McCoy v. Shaw (1928) 277 U.S. 302; Johnson v. New Jersey (1966) 384 U.S. 719, 735).

A. The Reasonableness of Specific Accounting Procedures is Properly One of State Law.

The instant decision of the California Public Utilities Commission was summarily affirmed by the California Supreme Court. The basis for such decisions rests substantially on interpretations of California Law. It was not necessary to consider any Federal issues in those opinions. Thus, petitioners are not entitled to a review by this Court of the California decisions.

The Commission was required to consider the proper interpretation of California Public Utilities Code Sections 451 and 454 which provide for reasonable ratemaking procedures. Likewise, the California Constitution, Article XII, guarantees to the people in California just and reasonable utility rates as determined by the Commission. The Commission was required to determine the proper treatment for certain unpaid tax revenues in light of these local statutes.

It is presumed that respondent Commission dealt fairly with petitioners in fixing rates. The Federal courts will not interfere with such decisions if the utility was given a fair opportunity to present its claims (Los Angeles Gas & Electric v. CRC, 58 F 2d 256 (D.C. Cir 1932), Aff'd 289, U.S. 287; Ashbury Truck Company v. CRC, 52 F 2d 263 (D.C. Cir 1931), Aff'd 287 U.S. 570).

In the instant case, it is apparent that the petitioners have had the benefit of extensive consideration for their claims on numerous opportunities before the Commission and California Supreme Court. Under Sections 451 and 454, supra, "the Commission has the power to . . . disallow expenditures that the Commission finds unreasonable." Pacific Tel. & Tel. v. PUC (1965) 62 C 2d 634, 647. "The same rule applies where . . . accounting

practices result in unreasonably inflated tax expense." San Francisco v. PUC (1971) 6 C 3d 119, 126.

In the instant case, petitioners argued before the Commission that they were entitled to retain funds collected from the ratepayers for taxes not actually paid to the Federal Government. The Commission determined that petitioners contentions were unreasonable by its finding of imprudence. This issue was considered before the Commission during hearings and rehearings as well as before the California Supreme Court on three separate occasions (San Francisco v. PUC (1971), supra; City of Los Angeles v. PUC (1972), supra; City of Los Angeles v. PUC (1975), supra).

B. California Law Prevents a Utility From Earning a Profit on Expenses Charged to Ratepayers.

California has determined that the tax benefits involved here result in permanent tax savings. It has also determined that a utility's expenses are payable by ratepayers only on a dollar-for-dollar basis. Southern California Edison v. PUC (1978) 20 C 3d 813, cert den - U.S. -. It therefore follows that any accounting procedure which inflates tax expense to ratepayers above that actually paid to IRS, is violative

of this State regulatory principle. Petitioners have accumulated over $1 billion from ratepayers in tax expense that will not be paid to the Federal Government. Yet they have been ordered by the Commission to refund only about $2 million. Petitioners have already unjustly profited from their imprudent conduct. To award them even more would make a mockery of state law.

C. Pacific is Precluded From Arguing That The Instant Decision Violates the Supremacy Clause the United States Constitution By Their Failure to Raise This Issue Before the California Supreme Court.

Public Utilities Code Section 1757 delimits the scope of judicial review for Commission decisions. Under this section, an applicant is precluded from seeking judicial review for issues and arguments not previously considered by the Commission on Petition for Rehearing. This limited scope of judicial review has received the approval of this Court in relation to matters not previously raised in the lower state court. New York ex rel Bryant v. Zimmerman (1928) 278 U.S. 63; Street v. New York (1969) 394 U.S. 576, 581-585.

In the instant case, Pacific argues before this Court that the Commission's decision violates Article VI of the United States Constitution. This argument was

not presented to the California Supreme Court. The failure of Pacific to raise the issue precludes review by this Court. Edelman v. California (1953) 344 U.S. 357; Barbour v. Georgia (1919) 249 U.S. 454; Mutual Life Ins. Co. v. McCrow (1903) 188 U.S. 291.

D. The Supremacy Clause Does Not Apply to The Present Proceeding

In the 1969 Tax Reform Act, Congress in Section 167(l)(2)(B) of Internal Revenue Code allowed public utilities who previously used straight line depreciation (Petitioners) to switch to accelerated depreciation only if they used a normalization method of accounting, pursuant to IRC section 167(l)(3)(G). The relevant Internal Revenue Code sections have reference to the taxpayer (Petitioners) and not the regulatory agency, the Commission. Secondly, the tax statutes have reference to a method of accounting. There is no reference to the abrogation of ratemaking principles in dealing with the reserve created by accounting methods. Thirdly, the tax statutes do not deal with the treatment of the reserve created by normalization accounting. General, Pacific and the Commission place primary emphasis on Treasury Regulation 1.167(l) - (l)(h)(6) to support their respective positions in regard to the proper

treatment of the deferred tax reserve. Again, as pertinent here, the regulation has reference to the taxpayer and not the regulatory agency.

During the course of Congressional debate, the House of Representatives considered language which would prohibit a State regulatory Commission from computing accelerated depreciation with flow through.[17] The House commented that these initial proposals would have the following effect: "If the taxpayer seeks to use accelerated depreciation, the regulatory agency will be permitted in effect to force the taxpayer to straight line depreciation by not permitting normalization. The regulatory agency will not, in such cases, be permitted to require flow through of deferred taxes." (H.R. Report #91 - 413, 91st Congress, 1st Session 1784.)

Congressman Wilbur Mills objected to these provisions because he believed Congress had no power to tell the California Public Utilities Commission how to fix its intrastate telephone rates. (Hearings on H.R. 6659, House Ways and Means Committee 3887, 91st Congress (1969).) The views of chairman Wilbur Mills prevailed. Consequently, the ultimate legislation did not restrict

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[17] H.R. 6659 as originally introduced on February 7, 1969. See also H.R. 8987.

the power of State regulatory commissions such as the California Public Utility Commission. (Section 441 Tax Reform Act 1969, Internal Revenue Section 167(l)(3)(G) and 167(l)(2)(B).)

From this brief summary of the Legislative history, it is apparent that Congress made a deliberate choice to permit State regulatory commissions wide latitude in setting rates, without eliminating the tax advantages contemplated by Internal Revenue Code Section 167(l)(3)(G) The effect of possible conflict between Treasury regulations and juisdiction of the Federal Power Commission was recently considered in California v. FPC (1974) 506 F 2d 228. In that case the Court ruled that "certainly nothing in either the Tax Reform Act of 1969 or general principles of administrative law require the FPC to defer to the judgment of the Treasury on the proper method of accounting." Id. at 232. See also FPC v. Memphis Light & Water Div. (1973) 411 U.S. 458, 466.

II. Petitioners Improperly Seek an Advisory Opinion From This Court.

To support its thesis that the instant decision will cause adverse tax consequences, General and Pacific solely rely on self-serving opinions obtained

by petitioners from the Internal Revenue Service. The opinions referred to in Appendices D and E were framed in terms of the facts presented by petitioners. The relevant regulatory rules and state laws were not considered by the Internal Revenue Service since Petitioners failed to deliniate them when seeking the proffered opinions. The taxpayers, petitioners herein, were in the unusual position of requesting that the Internal Revenue Service issue a decision which obstensively would increase their taxes. The opinions obtained were merely of the individual persons within the Internal Revenue Service who issued them. Bartells v. Burmingham (1947), 322 U.S. 126; Stub, Overbeck & Associates v. U.S. (1971), 445 F 2d 1142; Lincoln Savings & Loan v. Commissioner (1970), 422 F 2d 90; see generally 1 Mertens Federal Taxation Section 3.20.

Whether the interpretive rulings of the IRS will become the litigating position of the Department of Justice is purely speculative, especially in light of the many relevant facets of state, federal and regulatory law that were ignored by IRS in rendering its opinions. Therefore, at the present time there exists no conflict between the Commission decision and any other competent tribunal. Even if the advisory opinion of IRS

does become the litigating position of the Department of Justice, there will be no judicial or administrative ruling until a decision is rendered by the United States Tax Court (26 U.S. Code 7442), the United States District Court (28 U.S. Code 1346), or the United States Court of Claims (28 U.S. Code 1491), depending upon which avenue of litigation is pursued. Decisions of the Tax Court and District Court are reviewable in the United States Court of Appeals (26 U.S. Code 7482, 28 U.S. Code 1291) and thereafter to the United States Supreme Court by certiorari. Court of Claims decisions are directly reviewable to the United States Supreme Court by certiorari. Furthermore, federal courts are prohibited from issuing declaratory judgments on tax matters. 28 U.S. Code 2201. Therefore, the process of even considering the tax issue has not even begun.

What Pacific and General seek to do by means of the submitted letters from IRS is to create the erroneous impression that there is but one way to normalize taxes. This is patently not true. The statutes require that two items, tax reserve and tax expense, be calculated over the same period of time. It left state regulatory discretion to resolve how those items should be calculated in light of state regulatory principles.

This is precisely what the Commission has done.

All of the above serves as a means to illustrate that the issue before this Court is not the interpretation of a federal tax statute, but the regularity of the California Commission in applying state regulatory principles. The tax issue may eventually find its way to this Court, but only if the Justice Department decides even to litigate after thoroughly analyzing all parameters to the tax issue.

Internal Revenue Code contains numerous provisions for the resolution of tax controversies on an administrative level (26 CFR Sections 601.106-107 and IRC 7121) and judicial level (See IRC 6211 to 6216). It is well established that this Court will not consider the challenges of the taxpayer until there is an actual case or controversy. Section 6212 provides that the Commissioner will issue the taxpayer a 90-day letter advising him that there is in fact a controversy, which has not been resolved at the administrative level. By the terms of this letter, the taxpayer then is given 90 days to petition for a determination or resolution of the controversy before the United States Tax Court. In the alternative, the taxpayer may secure a judicial resolution of an actual claim by paying the

the disputed tax and seeking the refund in the District Court (28 U.S. Code 1346). Under either of these approaches, the Court knows that it is considering an actual controversy.

In the instant case, petitioners have chosen neither route. The disputed taxes have not been paid to the government, and no suit for a refund has been filed. Likewise, the Petitioners could have sought the 90-day letter, or judicial review in the United States Tax Court. Instead, they seek an advisory opinion from this court that the personal opinions of certain specified officials in the Internal Revenue Service are correct. Such advisory opinions are beyond the jurisdiction of this Court (Article III, U.S. Constitution).

III. The Decision is in Conformity With The Tax Statutes and Regulations And With State Law.

A. Accelerated Depreciation.

Petitioners lay primary emphasis on Treasury Regulation 1.167(l) - (l)(h)(6) for their contention that the Commission Decision violates IRC 167(l)(3)(G) and 167(l)(2)(B). Treasury Regulation 167(l) - (l)(h)(6) purports to govern whether or not normalized accounting is used in calculating the tax benefits associated

with accelerated depreciation. The regulation states that the amount of the deferred tax reserve deducted from rate base must not "exceed the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense." Under the Commission's formula both tax expense and the deferred tax reserve are computed over the same four year period as mandated by 1.167(l) - (l)(h)(6)(i). This is accomplished by taking an average of the four years and deducting the average amount from the test year rate base. A four year averaging method is used because of the abnormal growth of the deferred tax reserve. For instance, between 1973 and 1976 the deferred tax reserve disproportionately grew from \$136 million to \$430 million, more than a 300% increase. California law clearly requires accounting for this abnormal increase in the future tax reserve, when that "particular expenditure is extraordinary." City of Los Angeles v. PUC (1972) 7 C 3d 331, 347.

Based on a finding (Finding 5) that the growth in the deferred tax reserve is abnormal, the Commission was legally required to make adjustments in order to reflect the extraordinary growth in the tax reserve. This it has done.

Because the IRS regulations require that tax expense be computed over the same period of time, the Commission averaged the tax expense over the same four year period for which it averaged the deferred tax reserve.

In averaging the tax expense over the four year period, the Commission noted that because the abnormally growing deferred tax reserve is deducted from rate base, there will be less revenue to be taxed. The smaller amount of revenue will then produce less tax expense because total taxable income will be decreased. Because all cost of service items are held constant in this calculation, pursuant to City of Los Angeles, supra, there is decreasing tax expense over the four year period. Just as with the average tax reserve, the test year is adjusted by the average tax expense.

The IRS regulation set up an amorphous formula with which to calculate tax expense and deferred tax reserve over the same period of time. State ratemaking principles dictate that figures averaged over a period of years should be used to calculate these items. This the Commission has done. Because no more precise formula was called for by the Treasury regulations, the Commission's formula should not be rejected. "When the Congress, as here, fails to provide a formula

for the commission to follow, courts are not warranted in rejecting the one which the commission employs unless it plainly contravenes the statutory scheme of regulation." Colorado Interstate Gas Co. v. FPC (1924) 324 U.S. 581, 589; FPC v. United Gas Pipe Line Co. (1967) 386 U.S. 237, 87 S Ct 1003, 68 PUR 3d 321, 328.

The Commission assumptions underlying the treatment of tax expense are supported by exhibits submitted by Pacific and General and, further, by the fact that the effective tax rate has been declining (Decision 25A).

Pacific and General seek to buttress their interpretation of the tax statutes and regulations by reference to Example 1 of 1.167(1) - (1)(h)(6). Such reliance is misplaced. Example 1 assumes a historical "recorded test period," whereas the California Commission uses a future estimated test period. Furthermore, the example assumes that the period used for computing tax expense is the same as the recorded test period. This is not applicable to the formula adopted by the Commission, which makes adjustments to test year expenses because of the extraordinary growth of the deferred tax reserve, in accord with State law. City of Los Angeles, supra. In fact, none of the examples referred to applies to the precise procedure used by the Commission. At any rate,

it is apparent that example 1 operates on a different set of assumptions than that used by the Commission and is not applicable to the present case.

The purpose of the ratemaking process is to predict as reasonably as possible future revenues and expenses. Pacific Tel. & Tel. v. PUC (1965) 62 C 2d 634, 645. Based on this process, the Commission computed the affect of the abnormal growth of the deferred tax reserve, using normal ratemaking procedures previously approved by the California Supreme Court. In doing so, there is no error.

B. Investment Tax Credit.

The Commission adopted a procedure called annual adjustment in calculating the investment tax credit. The process involves reducing base rates each year based on estimates of that year's ITC. Cost of service is reduced by a rateable portion of the estimated amount of that year's ITC. In making the adjustment, all other rate base figures are held constant. Because ITC increases abnormally in relation to other expenses, this is a proper ratemaking procedure in accord with City of Los Angeles, supra.

C. Prior Commission Decisions Using Methodologies Different From Those Advocated by Petitioners Have Not Resulted in Tax Benefit Ineligibility.

Petitioners argue that any ratemaking methods other than their own, including flow through, are in conflict with the federal tax statutes and will result in ineligibility. Pacific was on accelerated depreciation with flow through until July 23, 1974, Pacific Tel. & Tel. (1974) 77 Cal PUC 117, as was General until November 26, 1974. General Tel. (1974) 77 Cal PUC 590.

Thus, for a period in excess of four years both petitioners had their rates set on the basis of accelerated depreciation with flow through. During this entire period the provisions of 167(1)(3)(G) and 167(1)(2)(B) in regard to accelerated depreciation and 46(f) in regard to ITC were in full force and effect. If the arguments of the utilities are valid then Petitioners have already lost their eligibility. Yet they obviously have not. In fact Pacific has just recently been cleared by Internal Revenue for any back tax liability prior to the year 1974. (Application 58223, Item 17.) General has not reported any lost tax benefits for the similar period of time.

Also, in Southern California Gas Company (1975) - Cal PUC -, Decision No. 85354, the Commission set the utility's rates based on flow through, as were

those of Southern California Edison Company (1975) - Cal PUC -, Decision No. 85294. Although it was argued that ineligibility would result, there have been no reports of lost eligibility.

Furthermore, in the case of Washington Utility Commission v. Pacific Northwest Bell Telephone Co. (1971) 93 PUR 3d 275, a higher rate base deduction was taken than existed in the deferred tax reserve for the test year, a methodology that is nearly identical with the present procedure employed by the California Commission. Although it was argued that loss of eligibility for tax benefits would result, again there was no loss of eligibility. It should be noted that the Washington case involved a Bell system telephone company. Thus, the Bell system (AT&T) is cognizant of ratemaking methodologies that are different than their own and that have not in fact resulted in lost eligibility for tax benefits. The present case is very similar to the Washington case, and will not result in ineligibility. But for the recalcitrant efforts of Pacific and General to have themselves declared ineligible, the eligibility issue would be a dead issue today.

It is also worthy of note that the present Commission Decision is consistent with the methodology

employed in prior Commission decisions. For instance, a five year average was used for the investment tax credit rather than the test year figure in Southern California Gas Co. (1972), 74 Cal PUC 30, 49. In calculating state taxes, the Commission used a three year average flow through for accelerated depreciation in Pacific Tel. & Tel. (1974) 77 Cal PUC 117. The methodologies employed in these decisions were based on the extraordinary growth of the relevant tax expenses, the same reasoning applied in the present case.

It can thus be seen that the Commission Decision is consistent with past practices, both inside and outside California, is based on sound and consistently applied State regulatory policies, and has not and will not result in lost eligibility.

IV. To The Extent, If Any, That State Regulatory Action is Inhibited, The Treasury Regulations are an Unwarranted Interpretation of Congressional Tax Statutes.

Primary reference for Petitioners' contentions regarding the deferred tax reserve is placed on Treasury regulation 1.167(l) - (l)(h)(6). If this regulation is construed to require treatment of the reserve which is not required by the Congressional tax statutes 167(l)(3)(G) and 167(l)(2)(B), it is at variance with the statutes and must be rejected.

In this regard, it is important to place in perspective the regulatory power of the Commissioner of Internal Revenue. It has been stated that "treasury regulations and interpretations long continued without substantial change . . . are deemed to have received congressional approval and have the effect of law." Helvering v. Winmall (1938) 305 U.S. 79, 83 L.Ed 52. However, the present treasury regulations dealing with the deferred tax reserve do not merit this treatment, since they are first impression rules applied to the Tax Reform Act of 1969.

Additionally, the Treasury Department may not restrict or enlarge the scope of a statute or supply a purported omission or create an exemption. World Service Life Insurance Co. v. U.S. (1973) 417 F 2d 247; Smith v. CIR (1964) 332 F 2d 671; U.S. v. Marett (1963) 325 F 2d 28; Mertens, Law of Fed. Inc. Taxation Vol. 1 Sec. 3.21.

> "The United States Commissioner of Internal Revenue may not prescribe any regulations which are not consistent with the federal tax statutes or which add a restriction to a statute which is not justified by the statutory language or the intent of Congress." (Emphasis added.) Government of Guam v. Koster (1966) 362 F 2d 248.

It is clear from a reading of the tax statutes, as distinguished from IRS regulations, that the treatment

to be accorded the tax reserve by a state regulatory agency is not proscribed.

Originally, Congress had proposed statutory language which would have expressly prohibited a regulatory commission from imputing accelerated depreciation with flow through. H.R. Dep. No. 91-413, 91st Congress, 1st Session 1784. This language does not appear in the final version as passed in section 441 of the Tax Reform Act, at section 167(l)(3)(G).

It is apparent that after full consideration of the matter, Congress affirmatively deleted any reference to action by state regulatory bodies in regard to the treatment of adjustments to a reserve. It therefore follows that the California Commission, especially in light of Congressman Mill's acknowledgment of Congress's lack of authority to limit state regulatory powers, was free to pursue traditional ratemaking principles in its treatment of the phantom tax reserve.

Petitioners argue that no greater sum can be deducted from rate base than exists in the deferred tax reserve for the test year used in setting rates. This interpretation would succeed in limiting regulatory authority in treatment of the deferred tax reserve, where Congress had already deleted a proposal which would

have straight-jacketed state regulatory agencies in their regulatory function. It is improper to reintroduce by administrative interpretation a construction that was expressly sticken by the legislature. Border Pipe Line Co. v. FPC (1948) 171 F 2d 149, 152.

The above cited case lends weight to the proposition that Congress by affirmatively expunging language which would have restrained state regulatory bodies from traditional methods of handling the tax reserve, intended the converse: to wit, the state regulatory agencies were free and unfettered in applying traditional ratemaking principles to the tax reserve. Colorado Interstate Gas Co. v. FPC (1924) supra; FPC v. United Gas Pipe Line (1967) supra; California v. FPC (1974), supra.

V. If the Federal Statutes and Regulations Intrude on State Regulatory Practices They are Invalid, Void and of No Legal Effect

The Tenth Amendment to the United State Constitution provides that "The powers not delegated to the United States by the Constitution, nor prohibited to it by the States, are reserved to the States, or to the people."

The prohibition on federal interference with state sovereignty applies to tax legislation and

regulations. "This Court has never doubted that there are limits upon the power of Congress to override state sovereignty, even when exercising its otherwise plenary powers to tax or to regulate commerce . . ." National League of Cities v. Usery (1976) 426 U.S. 833, 842.

Pacific and General's interpretation of the Congressional statutes and Treasury regulations would unlawfully restrain State regulatory agencies in their lawful function of overlooking the monopoly practices of utilities. This is not a proper function of Congressional tax legislation. This Court in regard to federal legislation binding state governmental function has stated:

> "Congress may not exercise that power so as to force directly upon the States its choices as to how essential decisions regarding the conduct of integral governmental functions are to be made." Usery, at page 855.

That the regulation of monopoly utility practices is an essential function of the state is clear. Article XII, Section 23, of the California Constitution establishes the Public Utilites Commission with the duty to regulate and fix rates. California Public Utility Code Section 451 requires those rates to be just and reasonable. California law holds that the State has

complete control over the rates charged by public utilities operating within its borders. Law v. Railroad Comm. 184 C 737. The case of People v. Western Airlines, 42 C 2d 621, found the powers of the Commission over the regulation of rates to be broad and comprehensive.

It is clear that the proposition Pacific and General argue for would involve interpreting Congressional legislation and tax regulations as if they were directed at the State regulatory agencies. This is what is prohibited by the Usery case, as it would deprive the State of applying traditional regulatory principles in regard to the regulatory treatment to be accorded federal taxes. TURN suggests that in light of the Usery case the utility argument for conditioning tax benefits on state regulatory methodology must be rejected. If the tax statutes and regulations do indeed impose such conditions on state regulatory bodies, the statutes and regulations are invalid, void and of no legal consequence.

VI. The Commission, To The Limited Extent That It Has Reduced Rates and Ordered Refunds, Has Acted Properly.

Petitioners next argue that the effect of ordering

refunds and reducing rates results in confiscation of their property because they have not earned their rate of return. This argument basically reduces itself to the proposition that refunds and rate reductions are not appropriate unless the utilities have earned their authorized rate of return.

Similar propositions were dealt with in City of Los Angeles v. PUC (1972) 7 C 3d 331, 355-359, and were rejected by the Court. The point to be emphasized is that the present authorized rates of return are based on an erroneous tax expense treatment by the Commission. Because prior Supreme Court and Commission decisions have provided for refunds based on the correct treatment of the tax expense issue, the utilities have no justifiable argument against refunds, even if they have not earned their rate of return.

Furthermore, a utility in California is not allowed to earn a profit on its expenses of operation. Southern California Edison v. PUC (1978) 20 C 3d 813, cert den - U.S. - (1978). It is uncontested that General and Pacific charge to ratepayers in tax expense an amount in excess of the taxes it actually pays to IRS. Thus, if anything, it is ratepayer money that is being confiscated, not utility earnings.

Pacific and General misconstrue the nature of the deferred tax reserve. These are not investor supplied funds but funds taken (confiscated?) from ratepayers to allegedly pay the utilities taxes. Not one penny of the deferred tax reserve is investor supplied. To allow the utilities to retain any of these funds is a generous gratuity.

Not only are ratepayer funds used as a source of capital, but they are obtained at the rate of two dollars of ratepayer funds for every one dollar of utility expense, a 200% rate of interest. Pacific Tel. & Tel. (1968) 69 Cal PUC 53, 61-62. Thus, to fund the tax reserves of General and Pacific, totalling more than $1 billion, the utilities require more than $2 billion of ratepayer monies, absolutely none of which is actually used in payment of taxes.

Lastly, the California Supreme Court has already held that the use of a formula tied to the growth in tax benefits, does not render the use of the formula confiscatory merely because it reduces the allowable rate of return. City of Los Angeles (1975) 15 C 3d 680, 703.

In determining whether confiscation has occurred, it is relevant to look at the financial picture of

General and Pacific. The Commission noted (36A) that Pacific has increased its shares outstanding from 104 million in 1961 to 168 million in 1975, to over 181 million in 1976. Earnings per share have increased over this period from $1.46 to $2.06. Earned surplus has risen $245 million from 1972 to 1975 and Pacific's construction budget increased $225 million from 1971 to 1974. All this was achieved in spite of the fact that Pacific refunded $176 million and had rates reduced $90 million per year (36A). It must be remembered that Pacific and General were on accelerated depreciation with flow through until 1974. In spite of this, and consequent refunds and rate reductions, the utilities made impressive economic advances.

Furthermore, on August 16, 1974, Pacific filed a memorandum with the California Supreme Court in S.F. No. 23215 and S.F. No. 23218, asking the Court not to stay Decision No. 83162, but to allow the rate of return to remain in effect subject to refund. Pacific concluded its argument at page 7 with the assurance that "<u>Pacific is financially capable of any such refunds</u>." The Court, as part of its decision in <u>City of Los Angeles v. PUC</u> (1975) 15 C 3d 680, 708, made the rates subject to refund.

It should also be noted that the tax reserve exists theoretically to meet some future tax laibility. If in fact that liability accrues, Pacific's witness testified that the utility would have to fund repayment since the tax reserve has been expended. (Volume 4, Transcript, page 369.) If the utilites can do this to tax payments, they surely can do the same for refunds.

VII. Conclusion.

The petitions to this Court should be rejected out of hand because they seek an advisory opinion on tax issues that present no case or controversy. Furthermore, the decisions before this Court are sustainable on independent State grounds enunciated by the Commission and the California Supreme Court over the last 20 years. On procedural grounds, Pacific's petition is inadequate for failing to raise its Supremacy Clause argument to the state court.

Substantively, petitioners request this Court to order the State of California to adopt a ratemaking mechanism which would require California citizens to subsidize their utilities by paying phantom taxes that in fact are never incurred. The decision Petitioners

attack allowed them to retain 75% of these phantom taxes. If anything, California ratepayers should be made whole by returning all tax savings to the actual taxpayers, the citizens of California.

Dated: November 10, 1978.

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Nos. 78-606 and 78-607

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL., *Respondents.*

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL., *Respondents.*

On Petitions for Writs of Certiorari to the Supreme Court of the State of California

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PETITIONERS' REPLY BRIEF IN SUPPORT OF CERTIORARI

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November 1978

IN THE

Supreme Court of the United States

October Term, 1978

Nos. 78-606 and 78-607

The Pacific Telephone and Telegraph Company, *Petitioner,*

v.

The Public Utilities Commission of the State of California, et al., *Respondents.*

General Telephone Company of California, *Petitioner,*

v.

The Public Utilities Commission of the State of California, et al., *Respondents.*

On Petitions for Writs of Certiorari to the Supreme Court of the State of California

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PETITIONERS' REPLY BRIEF IN SUPPORT OF CERTIORARI

The Public Utilities Commission states in the conclusion to what is styled a brief in opposition that it agrees with petitioners and the United States that this Court should hear and decide the issue of tax eligibility

now. (PUC Br. in Opp. 14-15.) We assume that this is the true position of the Commission and that the title of its document is a mere bow to convention. However, there are comments in the body of the brief more consonant with the title than the conclusion that call for brief response.

First, we note some things not said in the Commission's brief. Significantly, the Commission does not try to pretend that the issue of eligibility for the tax benefits is not presented. (PUC Br. in Opp. 4.) The Commission does not follow the other respondents into their particular never-never land, where vindictiveness replaces rationality as the theme of utility regulation and an agency may act to pass through to ratepayers tax benefits that, once the agency so acts, no longer exist. (Cities Br. in Opp. 11-13; TURN Br. in Opp. 21-23.) Nor does the Commission urge, as do its would-be seconds, the mistaken proposition that the California Supreme Court affirmed some decision other than the one the Commission rendered. (Cities Br. in Opp. 11-13; TURN Br. in Opp. 21-24.) The Commission did not make, and the California Supreme Court did not pass upon, a decision that the rates prescribed for Pacific and General were just and reasonable even if eligibility for the tax benefits were lost and tax expenses were consequently higher and net revenues correspondingly lower than was assumed in the Commission's rate calculations.

The Commission likewise does not join in the transparently erroneous suggestion that, if this Court were to review a state decision expressly predicated on a particular interpretation of federal law, which immediately reduces the rates that certain utilities can charge and ultimately affects their tax liability, it would be

rendering an advisory opinion on the meaning of that law. (Cities Br. in Opp. 11-21; TURN Br. in Opp. 27-31.)

What the Commission does say in questioning aspects of the two petitions for certiorari is either as mistaken as the arguments of its fellow respondents or trivial or both.

Both trivial and mistaken is the discussion, extending over more than a page, of the specificity with which General and Pacific stated how they raised in the California Supreme Court the federal questions presented here. (PUC Br. in Opp. 4-6.) These questions were substantially the whole subject of the petitions for review below. The descriptions in the petitions for certiorari are full, fair and adequate. To allay any conceivable doubt, 10 copies of each of the petitions for review below are being lodged with the Clerk.

The Commission is plainly mistaken in the further suggestion that General and Pacific differ in their view of the question of statutory construction or that the statement of the question by one or the other, here or below, is somehow incomplete. (*Id.* at 6-7.) There can be no controversy over what the Supremacy Clause says and means. It says that the Constitution and laws of the United States made in pursuance of it "shall be the Supreme Law of the Land; and the Judges in every State shall be bound thereby . . . ." It means that whenever state authorities profess to apply federal law, and their interpretation of it is questioned, the issue arises under the Supremacy Clause.[1] The constitutional obli-

[1] Contrary to the Commission's suggestion, Pacific raised the issue of federal supremacy in its petition for writ of review to the California Supreme Court (pp. 62-63; *see also* pp. 32, 34) as well as in its reply brief in that court (pp. 23-24).

gation of the state judges and other authorities is to apply the law Congress has written, as this Court ultimately construes it, and not some other law of their own devising that departs from the Congressional mandate. There is no requirement of a talismanic invocation of the Supremacy Clause when it thus necessarily underlies any claim that a state has misread federal law.[2]

The Commission is also mistaken in its assertion that the question it has decided has no ramifications beyond the rates of the two California telephone companies. (*Id.* at 9-10.) Its own undertaking to apply precisely the same ratemaking methods challenged in those cases to another utility, *see Sierra Pacific Power Co.*, 23 P.U.R.4th 485, 489 (Cal. P.U.C. 1978), belies its assertion. The Commission furthermore has no power to control the use by commissions in other states of its regulatory methods as a model, regardless how peculiar to the situation of General and Pacific it may view its own action. The concern of the utilities that have asked leave to present their views as amici curiae in support of the petitions is obviously well founded. The Treasury shares that concern, as evidenced by the memorandum of the United States.

That memorandum suffices, we believe, to dispel the impression that the Commission tries to create of uncertainty within the federal government. (*Id.* at 12-14.) It is clear that the Secretary of the Treasury and his delegate the Commissioner of Internal Revenue are convinced that the Commission misread the tax statutes. It is clear also that, if nothing further happens, the federal tax collection agents under the direction of the Secretary and the Commissioner will move to assess what will probably be upwards of $2 billion of tax deficiencies against the two petitioners.

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[2] *Bridge Proprietors* v. *Hoboken Co.*, 1 Wall. 116, 143 (1864); *see also New York ex rel. Bryant* v. *Zimmerman*, 278 U.S. 63, 67 (1928); *Konigsberg* v. *State Bar of California*, 353 U.S. 252, 254 (1957).

So far as the Commission's arguments on the merits are concerned (*id.* at 8-9, 10-12), those can be dealt with when the cases are heard on their merits. What is significant at this stage is that the affected utilities, the agency whose order is in issue and the United States are at one on the desirability of immediate review by this Court.

Respectfully submitted,

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October Term, 1978

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v.

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Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said Public Utilities Commission, et al.,
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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

Pursuant to Rule 42(3) of the Rules of this Court, the Edison Electric Institute ("EEI") respectfully moves the Court for leave to file the brief *amicus curiae* annexed hereto. While Petitioner and Respondent Communications Workers of America have granted consent,[1] the other Respondents have refused to do so.

1. Copies of the consents have been filed with the Clerk of the Court. As of the date of this Motion, Respondent Toward Utility Rate Normalization has not responded to EEI's request for its consent.

Interest of *Amicus Curiae*

EEI is the national association of electric utility companies. Its members serve more than 99% of all customers of the investor-owned segment of the utility industry and about 77% of the Nation's electricity users. Among EEI's interests are the development nationally of sound policies and procedures for the establishment of rates and tariffs by regulatory agencies.

This case involves contrary interpretations of the Internal Revenue Code ("Code") by the Internal Revenue Service and a state regulatory commission. The Code provides for reductions in currently payable federal income taxes if two conditions are satisfied: one, a utility follows certain accounting procedures; and two, the utility's state regulatory commission adopts a consistent ratemaking treatment. For Petitioner, the accounting and ratemaking procedure is called "normalization", as specified by Congress. The California Public Utilities Commission ("Commission") claims that the ratemaking treatment it has ordered for Petitioner is "normalization", but the Internal Revenue Service has determined that it is not "normalization", and that, if the Commission's Decision is applied to Petitioner, Petitioner will no longer qualify for the reductions in current federal income taxes. The inconsistency thereby created subjects Petitioner to the loss of substantial federal income tax benefits and to enormous financial risk.

EEI members, like Petitioner, are subject to both federal and state regulatory jurisdiction. At the federal level, EEI members are subject to the policies established by Congress, including the provisions of the Internal Revenue Code. At the state level, EEI members are subject to the ratemaking authority of state regulatory bodies. The various states have provided differing accounting and ratemaking treatment of federal income tax expense, as was recognized by Congress when the current accelerated depreciation and Investment Tax Credit provisions were enacted.

The decision of the Commission is of great importance to the member companies of EEI because the Commission has made and is enforcing an interpretation of the federal tax laws contrary to the interpretation of the Internal Revenue Service.[2] The Commission has acted on matters which are reserved, in our federal system, for exclusive determination in the federal domain.

The decision of the Supreme Court of the State of California, in failing to review the decision of the Commission, appears to leave the Commission free to interpret the Internal Revenue Code in a manner at odds with the interpretation of the Internal Revenue Service. This result is of substantial importance not only to Petitioner, which has very large sums at risk from the Commission's Decision, but also to EEI's members. Petitioner has referred to $218,000,000 as the amount of its deferred federal income taxes in 1977. The income statements of EEI's members for 1977 showed amounts of deferred federal income taxes resulting from liberalized (accelerated) depreciation and the Investment Tax Credit aggregating in excess of $2,000,000,000. EEI Statistical Year Book, EEI Pub. No. 78-3, at 62. Estimates of the corresponding deferred amounts for 1978, by EEI's members, approach $3,000,000,000.

Adoption of the stated rationale for the Commission's decision by other regulatory agencies will imperil the continued eligibility of taxpaying public utilities for benefits specifically made available by Congress in the Internal

2. The Commission's September 13, 1977 Decision is unreported as yet, but is set forth at App. B, pp. 3A-74A of the Joint Appendix filed herein by Petitioner.

Revenue Code.[3] In the area of federal taxation, national uniformity is of particular importance, yet it is threatened by variable and inconsistent determinations by state regulatory bodies. The disregard for the requirements of federal law evidenced by the actions of the Commission, if emulated by other state regulatory bodies, will make a shambles of the Internal Revenue Code, contravene the Supremacy Clause of the Constitution and, indeed, shake the very foundation of our federal system.

EEI, as a national association, holds a position from which it can meaningfully present the national importance of the issues herein and their relationship to the regulation of utility rate tariffs. Taking a broader view than is normally available to the individual parties, the annexed brief *amicus curiae*, in addition to endorsing the arguments of Petitioner, demonstrates the unmistakable Congressional intent in having determinations of eligibility for federal tax law benefits made at the federal level and not usurped by state regulatory bodies.

3. The Commission's Decision may be read by regulatory bodies in other states as precedent for such bodies to apply their own differing interpretations of the Internal Revenue Code to those EEI members subject to their jurisdiction.

Conclusion

For the reasons stated above and in the annexed brief, EEI requests leave to file the annexed brief *amicus curiae* in support of the petition for a writ of certiorari.

Respectfully submitted,

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October 25, 1978

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Supreme Court of the United States

October Term, 1978

No. 78-606

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Petitioner,

v.

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Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

The Edison Electric Institute ("EEI") supports the petition of The Pacific Telephone and Telegraph Company ("Pacific") for a writ of certiorari to review the judgment of the Supreme Court of the State of California in *The Pacific Telephone and Telegraph Company* v. *The Public Utilities Commission of the State of California, et al.,* 21 Cal. 3d, Official Advance Sheets, No. 21, minutes, p. 3 (1978). In that decision, the California Supreme Court refused to review Decision 87838 ("the California Deci-

sion") issued on September 13, 1977 by the California Public Utilities Commission ("Commission").

Interest of *Amicus Curiae*

The interest of *amicus curiae* is set out in the motion for leave to file, which is bound together with this brief.

Statement

The Commission proceeding considered the ratemaking treatment of federal income taxes as affected by Pacific's use of accelerated depreciation and the Investment Tax Credit ("ITC") as provided in §§ 167 and 46(f) of the Internal Revenue Code ("Code").[1] Both accelerated depreciation and ITC are available to reduce the federal income taxes actually paid during the years in question provided that specified ratemaking procedures are followed. The Commission specifically found that Pacific's continued eligibility for these provisions was "an important goal of this Commission in this decision" (47A):

> In the final analysis *a loss of eligibility to the utilities would not only create service problems . . . but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress.* We believe that eligibility for these tax benefits should be maintained and proceed on this basis. (Emphasis added) (22A).

1. The Commission's decisions respecting the ratemaking treatment of federal income taxes in the 1970 and 1972 applications had been set aside by the California Supreme Court in *City and County of San Francisco* v. *Public Utilities Commission,* 6 Cal. 3d 119 (1971) and *City of Los Angeles* v. *Public Utilities Commission,* 15 Cal. 3d 680 (1975), respectively and remanded to the Commission for further consideration. The two remanded cases were consolidated with consideration of the federal income tax aspects of the 1975 rate application filed by Pacific (97A-99A). (Citations in the form of a number followed by "A" refer to the specified page of the Joint Appendix, as filed herein by Pacific.)

If Pacific's eligibility for these benefits is to be maintained, two conditions must be fulfilled. First, the utility must maintain its regulated books of account on a normalization basis. This Pacific has done.

Second, the state regulatory commission must employ "normalization" ratemaking consistent with §§ 167 and 46(f) of the Code.[2] This is the heart of the present controversy. The Commission has independently defined normalization under the Code, and required Pacific to act in accordance with that definition. However, the Internal Revenue Service ("IRS") has ruled that the Commission's definition is inconsistent with the Code. Accordingly, Pacific faces the dilemma of losing the tax benefits, and suffering grievous loss, because the Commission erroneously insists that it has the authority to interpret the Code in a manner inconsistent with the interpretation of the IRS.

The Commission recognized that the question of Pacific's eligibility for both accelerated depreciation and ITC was "a case of first impression under the tax laws" (40A). However, the Commission did not seek any determination from the IRS of whether the ratemaking treatment imposed by the Commission met federal requirements for continued eligibility. The Commission also refused to stay its Decision pending determination by the IRS of Pacific's continued eligibility.[3]

Pacific thereupon sought, and obtained, rulings from the IRS respecting Pacific's continued eligibility for accelerated depreciation and ITC under the ratemaking ordered by the

2. See Petition at 5-6; 11A-12A.

3. This failure led to strong dissents by Commissioners Symons (71A) and Sturgeon (73A).

Commission.[4] These rulings determined that Pacific would not be eligible for the tax benefits because of the ratemaking treatment being applied.

While the majority of this state commission stalwartly maintains that the Commission has provided for Pacific's eligibility at federal law, two of the three Commissioners comprising the majority entered a concurring opinion acknowledging the need for prompt review by this Court:

> The *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be. (Emphasis in original) (70A).

This Court should grant certiorari to correct the wrongs against the Petitioner and to permit the achievement of a specified Congressional purpose. If the Commission's Decision is allowed to stand, the Commission may in the future attempt to apply the same, or equally improper, regulatory ratemaking methods to electric companies. Moreover, other state agencies and participants in rate proceedings will be given the signal that they can interpret and frustrate the requirements of federal law with impunity.

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4. Two rulings on the issues raised by Pacific were ultimately issued by the IRS, one on June 8, 1978 (95A-115A) and the other on July 27, 1978 (133A-142A). Since Pacific's appeal to the California Supreme Court was pending at the time the first ruling was received, a copy of that IRS determination was lodged with the California Supreme Court.

ARGUMENT

I

The California Commission, By Reason of the Supremacy Clause of Article VI, Lacks the Authority to Interpret the Federal Tax Laws In a Manner Not Consistent With an Internal Revenue Service Interpretation.

California's Decision attempts to establish, absent IRS review or consent, the eligibility requirements for accelerated depreciation and ITC available under the Code. In so doing, the California Commission invades an exclusive domain of the federal government and attempts to avoid giving effect to Congressional policies underlying these eligibility requirements. Moreover, despite the obvious need for national uniformity in this area, i.e., a single arbiter of the meaning of the Internal Revenue Code, California has arrived at conclusions that have been found by the IRS to be contrary to the requirements of the controlling federal law and regulations. This interference in an area that is preempted by the federal government has produced a grave federal-state conflict (which will continue if this precedent is allowed to stand). California's action is contrary to the Supremacy Clause of Article VI.

A. Congressional Intent

The reasons underlying Congress' authorization of accelerated depreciation and ITC are discussed in the Petition.[5]

Two aspects deserve emphasis. First, a primary motivation for both of these provisions was Congress' intent[6] to

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5. Petition at 4-8.

6. See H.R. Rep. No. 83-1337, 83rd Cong., 2nd Sess. 24 (1954); H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. 23-26 (1971).

stimulate capital investment. For public utilities, the normalization ratemaking required by Congress provides more internally generated capital, in furtherance of this policy. Second, Congress made an explicit determination to restrict the future availability of these provisions to utilities regulated on a normalization basis, so as to hold the resulting reductions in utilities' taxable income, and hence taxes payable to the federal government, within limits.[7]

B. The California Decision

The California Decision indicates both an awareness of, and a dissatisfaction with, the means chosen by Congress to further the policies behind the accelerated depreciation and ITC provisions of the federal tax laws.[8]

The Commission stated that these statutory provisions have forced "everyone involved in setting rates to go through a series of contortions and distortions to attempt to comply with or legally avoid the effect of the existing tax laws. . ." (45A). In the California Decision, these "contortions and distortions" have taken the form of an attempt to redefine normalization accounting and the eligibility requirements for accelerated depreciation and ITC.

Despite the novelty of the accounting method ordered by the California Commission,[9] the Commission casually assumed that its method would meet the requirements of the federal tax laws and be consistent with an IRS determination.[10] The Commission also failed to provide for any safe-

7. H. R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-176 (1969).

8. 12A, and see the "Epilogue" to the Decision (43A-45A) and Finding 17 (48A).

9. See 40A.

10. See 49A-50A.

guards in the event the IRS disagreed, safeguards which are necessary to avoid dire consequences to Pacific and its customers in the event the IRS decision differed.

C. Preemption

The well established legal standard for preemption[11] was repeated in this Court's decision just last term in *Ray v. Atlantic Richfield Company*, 435 U.S. 151 (1977). While certain aspects of federal endeavor touch upon elements of this standard, federal taxation is the very purse string of the federal government and manifests preemption in a mature and fully developed fashion. The criteria established by this Court, case law, and the Code's legislative history clearly support the conclusion that the California Decision intrudes improperly into matters reserved for federal determination.

There can be no doubt that federal tax statutes are pervasive, and delineate specifically the eligibility requirements for accelerated depreciation and ITC.[12] In fact, the legislative history of these statutes indicates that Congress was specifically aware of the efforts of regulatory agencies to avoid implementing the policy objectives underlying these laws.[13] Accordingly, Congress mandated specific forms of ratemaking treatment of accelerated depreciation and ITC in order that eligibility be maintained. These statutory provisions are supplemented by the regulations issued by the Treasury Department further prescribing the neces-

11. See, e.g., *Rice* v. *Santa Fe Elevator Corporation,* 331 U.S. 218, 230 (1947).

12. See Petition at 5-8.

13. See H. R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-172 (1969).

sary conditions for eligibility.[14] In the face of this legislative history, California should not enter this area of pervasive and specific federal regulation by construing Petitioner's eligibility for certain federal tax benefits inconsistently with the IRS.[15]

The need for dominance of the federal interest in this area of regulation is apparent. The California Decision, if upheld, would hamper Congress' ability to use the tax laws to effectuate critical national economic policy goals and to assure a continued and stable flow of revenues to the federal treasury.

By its very nature, interpretation of federal tax law requires national uniformity. Our unified system of federal taxation is predicated on a structure whereby the authority to interpret the various provisions of the tax laws is vested in one, and not many, regulatory bodies. The Internal Revenue Service alone has the primary authority to determine the meaning of the federal tax laws and the eligibility requirements contained therein.

The approach followed by California could potentially fragment this authority and disperse it to numerous state

14. See Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) § 1.167(1).

15. See *Burnet* v. *Harmel*, 287 U.S. 103 (1932); and ***Helvering*** v. *R. Douglas Stuart*, 317 U.S. 154, 161 (1942). In a case involving a conflict between a state regulatory commission and the Federal Power Commission, a federal court prohibited the state commission from interfering with actions of the federal regulatory agency. *Federal Power Commission* v. *Corporation Commission of the State of Oklahoma*, 362 F. Supp. 522 (W.D. Okla. 1973), ***aff'd*** 415 U.S. 961 (1974). The Court said: "The unequivocal language of the Orders shows that the Oklahoma Corporation Commission is ***dissatisfied*** with the Federal Power Commission's producer rate regulation and that Defendant would, therefore, ***like to substitute its judgment for that of the Plaintiff*** [***Federal Power Commission***] ***regarding such rates*** . . . It is obvious that the Orders in question would circumvent Plaintiff's [Federal Power Commission] regulatory jurisdiction." (Emphasis added) 362 F. Supp. at 537-38.

regulatory bodies in addition to the Internal Revenue Service. As a result, taxpaying utilities are put in an impossible position. Rates set on the basis of a state commission's assumptions of the existence of federal tax benefits are not reasonable when the controlling federal agency, the IRS, concludes that the tax benefits will be terminated as a result of the state commission's decision.

Clearly, this is an instance where a state seeks to frustrate Congressional intent in an area of paramount federal authority. California's Decision cannot be allowed to stand.

D. Direct Conflict

This Court recently reaffirmed the rule that state action is unconstitutional if it conflicts in fact with federal law, even where Congress has not exclusively occupied an area. *Ray* v. *Atlantic Richfield Company, supra.*

In the instant controversy, Pacific is in the middle of a direct conflict between federal and state regulation, each regulator pulling in opposite directions. Pacific is either eligible for accelerated depreciation and ITC or it is ineligible; it cannot be both simultaneously. The California Commission has declared that Pacific is eligible. The Internal Revenue Service has ruled that under the Commission's Decision, Pacific will be ineligible.

> The Commission said:
>
> The methods described in findings 3 and 4 maintain the eligibility of the utilities to use accelerated depreciation and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General (49A-50A).
>
> The IRS said:
>
> [W]e believe that the Commission's annual average adjustment method is not a proper normalization method of accounting . . . Therefore, should the

> Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation . . . (113A).
>
> Accordingly, should Decision No. X of the Commission become a final determination pursuant to section 46(f)(4) [of the Code], we believe that its application for the adjustment of rates in years subsequent to the test year would be inconsistent with the requirements of section 46(f)(2) and would result in Pacific's . . . loss of eligibility for the investment tax credit under section 38.[16] (142A).

The conflict brought about frustrates the objectives of Congress. The IRS has determined that Congressional policies underlying the tax laws will be obstructed if the California Decision is not reversed.[17] The Decision boldly announces its disagreement with these policies and an intention to attempt to reach a result consistent with the law while frustrating to the maximum extent possible the underlying federal policy.[18]

Federal taxation is an area in which Congress has provided a pervasive scheme of regulation. The subject matter is one requiring uniform, national interpretation at the federal level. The Supremacy Clause requires that the state regulation must give way.

16. The interpretations of the Internal Revenue Service are to be accorded great weight since "[t]he construction of a statute by those charged with its execution should be followed unless there are compelling indications that it is wrong." *Beal* v. *Doe,* 432 U.S. 438, 447 (1977); *New York Dept. of Social Services* v. *Dublino,* 413 U.S. 405, 420 (1973).

17. 112A-113A, 142A.

18. 43A-45A.

II

The Action of the California Commission Constitutes a Violation of Substantive Due Process.

Certiorari should be granted because the action of the California Commission is an arbitrary and capricious denial of substantive due process under the Fourteenth Amendment of the Constitution. The Decision made no provision which would allow Pacific a reasonable opportunity to secure a ruling from the Internal Revenue Service on the issue of eligibility. The Commission's failure to incorporate this simple safeguard in its Decision was described by Commissioner Symons as "reckless" and by Commissioner Sturgeon as "cavalier".[19] Pacific has been placed at a totally improper, and unnecessary, risk. To date, the Commission's Decision is the final word, since that Decision controls the federal tax treatment available. However, unless this Court itself resolves the underlying issue of the propriety of the Commission's Decision, it will be impossible to determine whether the California Commission's interpretation is right or wrong. In the meanwhile, no

19. Commissioner Symons, dissenting, said: "California stands to lose at least a billion dollars, with nothing to gain, as the Public Utilities Commission majority again plays brinkmanship with the United States Government. There is no need to recklessly risk eligibility for such enormous sums in federal tax deferrals and federal tax forgiveness. . . . I cannot support a decision which fails to take the opportunity to resolve the 'eligibility' issue before the Commission decision is finalized and 'set in concrete'" (71A). Commissioner Sturgeon, dissenting, said: "The inconsistent and cavalier manner in which the majority treats the key issue of eligibility . . . warrants my strong dissent. . . . After recognizing and elaborating upon the importance of eligibility, the majority then, incredibly, moves quickly to jeopardize that eligibility by adopting a regulatory accounting scheme whose compliance with the standards of normalization established by the Internal Revenue Code and Treasury Regulations *must* be considered a matter of speculation" (Emphasis in original) (73A).

protection is given to Pacific. If this Court does not act, the ultimate determination will follow the tax assessments by the Internal Revenue Service many years in the future and Pacific will be compelled to pay out enormous amounts which it stands no chance of recovering.

EEI believes that the Due Process Clause requires the California Commission to treat Pacific in accordance with basic principles of fairness. These basic principles of fairness mandate that the Commission provide for (as distinguished from merely recognizing) the possibility of a conflicting IRS determination on eligibility by establishing some procedure either to maintain the *status quo* pending an IRS determination or, if permissible under state law, to undo the damage resulting from its order in the event the IRS denies eligibility.

It has long been the rule that the arbitrary exercise of power by the States is prohibited by the Due Process Clause. *Hurtado* v. *California*, 110 U.S. 516, 528, 532, 536 (1884). In *Atlantic Coastline Ry. Co.* v. *North Carolina Corporation Commission*, 206 U.S. 1, 20 (1907), the Court said that wherever the power of regulation is exerted in such an arbitrary and unreasonable way as to be, in effect, not regulation but an infringement on the right of ownership, such an exertion of power is repugnant to the Due Process Clause.

The Court has also overturned administrative action which it found to be "an exercise of arbitrary power, at variance with 'the rudiments of fair play' . . . long known to our law." *West Ohio Gas Co.* v. *Public Utilities Commission of Ohio (No. 1)*, 294 U.S. 63, 71 (1935); *Interstate Commerce Commission* v. *Union Pacific R.R.*, 222 U.S. 541, 547-8 (1912).[20] The Court's discussion of the limitations

20. *See also Morgan* v. *United States*, 304 U.S. 1, 22 (1938) where Chief Justice Hughes, speaking for the Court, said: "agencies . . . must accredit themselves by acting in accordance with the cherished judicial tradition embodying the basic concepts of fair play."

upon state legislative actions in *Day-Brite Lighting, Inc.* v. *Missouri*, 342 U.S. 421, 423 (1952) shows that substantive due process is a vital antidote to remedy extreme actions that reach beyond constitutional bounds and conflict with the requirements of federal law.[21]

This is an extreme case. The state regulation challenged herein is manifestly arbitrary, capricious and unreasonable. One may fairly inquire whether it was adopted only for the purpose of questioning and challenging the federal regulatory scheme established by Congress, rather than incident to the purpose of implementing utility rates.[22]

The issue of eligibility is of enormous importance to Pacific and its customers. In view of the express recognition that the case is one of first impression under the federal tax laws (40A), basic fairness and plain common sense point to the need for safeguards to protect Pacific in the event that an IRS determination conflicts with the interpretation of the Commission. The Commission's refusal to provide these safeguards fails to meet minimal standards of due process required by the Constitution.

21. *North Dakota Pharmacy Bd.* v. *Snyder's Stores*, 414 U.S. 156, 164-167 (1973); *Ferguson* v. *Skrupa*, 372 U.S. 726, 731-732 (1963); *Williamson* v. *Lee Optical Co.*, 348 U.S. 483, 488 (1955).

22. See, Concurring Opinion by Commissioners Gravelle and Dedrick (70A). In the Epilogue to its Decision, the Commission said: "This Commission believes that it has a legal duty to balance the interests of the utilities and the ratepayers and is attempting to do so, but finds itself more frequently hamstrung by the actions of Congress where it appears that the interests of the utility ratepayers are not adequately considered for whatever reason" (44A). In the body of its Decision, the Commission stated: "This horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator" (12A).

Conclusion

For all of the reasons stated above, Edison Electric Institute believes that this Court should grant the writ of certiorari requested by The Pacific Telephone and Telegraph Company.

Respectfully submitted,

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1978

NOS. 78-606 and 78-607

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

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v.

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Respondents.

MOTION OF THE SOUTHERN COMPANY FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* IN RESPONSE TO PETITIONS NOS. 78-606 AND 78-607, AND BRIEF *AMICUS CURIAE* IN SUPPORT OF CERTIORARI

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The Public Utilities Commission of the State of California, et al.,
Respondents.

MOTION OF THE SOUTHERN COMPANY FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* IN RESPONSE TO PETITIONS NOS. 78-606 AND 78-607

The Southern Company hereby respectfully moves for leave to file the attached brief *amicus curiae* in support of certiorari in the above case. The consent of The Pacific Telephone and Telegraph Company, General Telephone Company of California, and Communications Workers of America has been obtained. The consent of The Public Utilities Commission of the State of California, the City of

Los Angeles, the City of San Diego, the City and County of San Francisco and Toward Utility Rate Normalization was requested but refused.

The Southern Company is a Delaware corporation, with its principal place of business in Atlanta, Georgia. The Southern Company owns all of the outstanding common stock of Alabama Power Company, Georgia Power Company, Gulf Power Company, and Mississippi Power Company, each of which is an operating public utility company. Alabama Power Company and Georgia Power Company each own 50% of the outstanding common stock of Southern Electric Generating Company. The operating affiliates supply electric service in the states of Alabama, Georgia, Florida and Mississippi, respectively, and Southern Electric Generating Company owns generating units at a large electric generating station which supplies power to Alabama Power Company and Georgia Power Company.

The Southern Company is registered as a holding company under the Public Utility Holding Company Act of 1935. The operating affiliates and Southern Electric Generating Company are subject to the jurisdiction of their respective state regulatory commissions, which have broad powers of supervision and regulation over public utilities operating in the respective states, including their rates. The Federal Power Act subjects to regulation the operating affiliates and Southern Electric Generating Company as companies engaged in the transmission or sale at wholesale of electric energy in interstate commerce, including rates.

For federal income tax purposes, the operating affiliates use accelerated depreciation methods authorized by Section 167 of the Internal Revenue Code of 1954, as amended (the "Internal Revenue Code"). The operating affiliates are eligible to use accelerated depreciation methods because they employ a normalization method of accounting for the

federal income taxes deferred through the use of such methods.

The operating affiliates have invested substantial amounts in certain types of capital assets which made them eligible for the investment tax credit provided in Section 38 of the Internal Revenue Code. The operating affiliates are eligible for the investment tax credit because, in accordance with Section 46(f) of the Internal Revenue Code, for financial reporting and ratemaking purposes, they have followed a normalization method of accounting for the federal income taxes saved by the investment tax credit.

The Southern Company has a direct interest in the issues presented to this Court because its operating affiliates are regulated as to their rates for electric service and, in order for the operating affiliates to be eligible for accelerated depreciation methods and investment tax credit for federal income tax purposes, the respective regulatory commissions must agree that the operating affiliates employ for ratemaking purposes a normalization method of accounting which meets the requirements of the Internal Revenue Code. Should a state regulatory commission misconstrue the normalization requirements and apply such misconstruction in the ratemaking process, as The Public Utilities Commission of the State of California (the "California Commission") has done in the present case, then the operating affiliate whose rates were so determined would lose the benefits of accelerated depreciation and the investment tax credit, an event which would likely render it unable to discharge its legal duty to serve the public and to finance the payment of the federal income tax liability generated by such loss.

The Southern Company and other public utilities which have availed themselves of these important tax practices have a direct interest in urging this Court to issue the writs

of certiorari requested. The California Commission claims that it has invented a ratemaking method which preserves the tax benefits, yet reduces rates by flowing through a portion of the benefits to current customers. The actions of the California Commission have substantial influence on other ratemaking commissions which are now under great pressure to hold or reduce rates. As a result, should this Court not grant the petitions herein, many ratemaking commissions across this nation may follow the false lead of the California Commission and require public utilities to adopt erroneous methods of accounting for the tax benefits for ratemaking purposes. The Internal Revenue Service would then disallow the tax benefits and savings, and the public utilities would be forced to travel the time consuming route of seeking judicial determinations of the Internal Revenue Service actions. This time lag is no mere nuisance, for during this period such public utilities would amass incredible tax deficiencies and their ability to finance required plants and equipment likely would be impaired in light of their need to finance the tax liabilities. This predictable situation is harmful to The Southern Company and to the national interest, as public utilities may not be able to exist in such an environment and discharge their legal duties to serve the public's demand for utility services.

The Southern Company believes the views it seeks to present to the Court will contribute to the resolution of the issues in this case because the parties will not be able to present adequately the application of the issues (1) to public utility companies other than telephone and telegraph companies, (2) to public utilities which both before and after the enactment of the Tax Reform Act of 1969 used accelerated depreciation methods for federal income tax purposes and normalized the deferred taxes for ratemaking purposes; and (3) to public utilities whose state

regulatory commissions use ratemaking methods different from those employed by the California Commission.

WHEREFORE, The Southern Company respectfully requests this Court to permit it to file the brief *amicus curiae* which is submitted herewith.

Respectfully submitted,

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1978

NOS. 78-606 and 78-607

The Pacific Telephone and Telegraph Company,
Petitioner,

v.

The Public Utilities Commission of the State of California, and Robert Batinovich, Vernon L. Sturgeon, Richard D. Gravelle, Claire T. Dedrick, and William Symons, Jr., the members of said Public Utilities Commission, et al.,
Respondents.

General Telephone Company of California,
Petitioner,

v.

The Public Utilities Commission of the State of California, et al.,
Respondents.

BRIEF *AMICUS CURIAE* FOR THE SOUTHERN COMPANY IN SUPPORT OF CERTIORARI

The Southern Company hereby submits its brief in support of the petitions filed in Nos. 78-606 and 78-607 for writ of certiorari to review the judgment of the Supreme Court of the State of California entered on July 13, 1978, upholding the decision of The Public Utilities Commission of the State of California entered on September 13, 1977.

OPINIONS BELOW

The final judgment of the Supreme Court of the State of California, which is included in the Joint Appendix A, pp. 1A, of The Pacific Telephone and Telegraph Company and General Telephone Company of California (the "Petitioners"), is reported at 21 Cal. 3rd, Official Advance Sheets, No. 21, Minutes p. 3 (1978). The judgment was entered without opinion, one judge dissenting from the Court's refusal to issue a writ of review. The decision of The Public Utilities Commission of the State of California (the "California Commission"), which is included in the Petitioners' Appendix B, pp. 3A, is as yet unreported.

JURISDICTION

The judgment of the Supreme Court of the State of California was entered July 13, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. §1257(3).

QUESTIONS PRESENTED FOR REVIEW

Of the questions presented by the Petitioners for review The Southern Company will deal with the following:

1. Did the California Commission violate the provisions of Section 46(f) and Section 167(1) of the Internal Revenue Code of 1954, as amended (the "Internal Revenue Code") and therefore the Supremacy Clause of Article VI of the United States Constitution, by requiring Petitioners to pass on to their customers federal tax benefits of accelerated depreciation and investment tax credits, when Petitioners are forbidden by federal law to receive such tax benefits if they pass them on rather than having them available, as Congress contemplated, for capital investment?

2. Did the California Commission deprive the Petitioners of their property without due process of law in violation of the Fourteenth Amendment by making rates on the arbitrary assumption that Petitioners were eligible for accelerated depreciation and the investment tax credit, when the ratemaking methods used by the California Commission destroyed that eligibility?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

1. U.S. Const. art. VI.
2. U.S. Const. amend. XIV.
3. The Internal Revenue Code of 1954, as amended, §46(f) [26 U.S.C. §46(f)].
4. The Internal Revenue Code of 1954, as amended, §167(1) [26 U.S.C. §167(1)].

INTEREST OF THE SOUTHERN COMPANY AND ITS PUBLIC UTILITY SUBSIDIARIES

The Southern Company is a Delaware corporation with its principal place of business in Atlanta, Georgia. The Southern Company owns all of the outstanding common stock of Alabama Power Company, Georgia Power Company, Gulf Power Company, and Mississippi Power Company, each of which is an operating public utility company. Alabama Power Company and Georgia Power Company each own 50% of the outstanding common stock of Southern Electric Generating Company. The operating affiliates supply electric service in the states of Alabama, Georgia, Florida and Mississippi, respectively, and Southern Electric Generating Company owns generating units at a large electric generating station which supplies power to Alabama

Power Company and Georgia Power Company. Each operating affiliate is regulated as to its retail rates by its respective state commission and as to its wholesale (interstate) rates by the Federal Energy Regulatory Commission.

The Southern Company has a direct interest in the issues presented to this Court because its operating affiliates are regulated as to their rates for electric service and, in order for the operating affiliates to be eligible for accelerated depreciation and investment tax credit, the respective regulatory commissions must agree that the operating affiliates employ for ratemaking and financial accounting purposes normalization methods of accounting which meet the requirements of the Internal Revenue Code. Should state regulatory commissions misconstrue the normalization requirements of the Internal Revenue Code and apply such misconstruction in the ratemaking process, then the operating affiliates whose rates were so determined would lose the benefits of accelerated depreciation methods and the investment tax credit, an event which would likely render them unable to discharge their legal duties to serve the public and to finance the payment of the federal income tax liability generated by such loss.

STATEMENT OF THE CASE

The Petitioners are public utility companies whose rates for service are regulated by the California Commission. Since 1969, for federal income tax purposes, Petitioners have used an accelerated method of accounting for the depreciation of certain capital assets. Section 167(l) of the Internal Revenue Code, as applied to Petitioners, allows them to use an accelerated method of depreciation only if Petitioners follow a normalization method of accounting, whereby for ratemaking and financial reporting purposes Petitioners employ straight line depreciation.

The Petitioners have invested amounts in capital assets which made Petitioners eligible for the investment tax credit against federal income tax allowed by Section 38 of the Internal Revenue Code. The use of the investment tax credit by Petitioners is, by Section 46(f) of the Internal Revenue Code, conditioned on their use of a normalization method of accounting for the investment tax credit benefits for ratemaking and financial reporting purposes.

The California Commission entered a decision requiring Petitioners to employ for ratemaking purposes specified methods of accounting for the tax deferred by the use of accelerated depreciation methods and the tax benefit obtained through the investment tax credit. The Petitioners have been informed by separate rulings of the Internal Revenue Service that the methods the California Commission would require them to use do not meet the normalization requirements of Section 167(l) and Section 46(f) of the Internal Revenue Code, respectively.

The Supreme Court of the State of California affirmed the decision of the California Commission.

The California Commission has granted a stay of its decision pending the petitions for writ of certiorari by Petitioners herein. Should that decision be implemented, the Petitioners are faced with determinations by the Internal Revenue Service that, for federal income tax purposes, they are not eligible for the benefits of accelerated depreciation methods and the investment tax credit. With respect to the Petitioners' federal income tax deductions for depreciation expense, the Internal Revenue Service determinations, if sustained, would result in their being required to employ a straight line method in computing their federal income tax liabilities for all open tax years in which the Petitioners' rates were established (by retroactive effect, refund or otherwise) using the erroneous method of normalization. With

respect to the Petitioners' use of the investment tax credit, the Internal Revenue Service determinations, if sustained, would result in a total loss of the federal income taxes saved in all tax years of the Petitioners not closed to the assessment of a tax deficiency by any law or rule of law.

ARGUMENT

The decision below raises issues of importance to all public utilities which use accelerated depreciation methods for federal income tax purposes and which normalize the tax deferral for ratemaking and financial purposes, as do the operating affiliates of The Southern Company. The issues are important to all public utilities eligible for the benefits of the investment tax credit. In this brief, The Southern Company will show that resolution of the issues presented in this case is important to the financial stability of the nation's public utilities and their ability to discharge their legal duties to the public they serve, and that electric utility companies as well as other types of public utilities are affected by this decision.

The Southern Company operating affiliates now employ and since 1954 have employed accelerated methods of depreciating capital assets for federal income tax purposes. Throughout this period, the operating affiliates have normalized the effects of the use of accelerated depreciation methods and have used straight line depreciation for ratemaking and financial reporting purposes. Under a normalization method, the difference between the federal income tax generated by accelerated depreciation methods and a straight line method for a given year is added to a deferred tax reserve. The number of dollars in the deferred tax reserve represents the federal income tax expense deferral obtained by using a method of accelerated depreciation. At

the close of The Southern Company's federal income tax year ending December 31, 1977, the amount in its consolidated deferred tax reserve, representing the accumulated tax deferred by the use of accelerated depreciation methods, was $436,161,000.

The Southern Company operating affiliates have invested amounts in capital assets which made them eligible for the investment tax credit. The investment tax credit is normalized by adding it to a reserve for deferred investment tax credits and, for ratemaking and financial reporting purposes, amortizing such credits to income ratably over the life of the asset which generated the investment tax credit when placed in service. At the close of The Southern Company's federal income tax year ending December 31, 1977, the amount in its consolidated reserve for accumulated deferred investment tax credits was $220,153,000.

If the regulatory commissions responsible for approving rates of The Southern Company operating affiliates chose to reduce rates by tampering with the approved methods of normalizing investment tax credit and accelerated depreciation methods for ratemaking purposes and, in doing so, misconstrued the provisions of the Internal Revenue Code, as did the California Commission, then The Southern Company would be faced with an additional federal income tax liability equal to the amounts placed in its reserve for accumulated deferred investment tax credits in all years open for assessment of additional federal income tax. At December 31, 1977, this amount was $191,261,000.

In addition, The Southern Company operating affiliates would lose the use of the cash flow generated by the use of accelerated depreciation methods in all years affected by the rate orders setting rates for service using an erroneous method of normalization of the deferral of federal income tax by accelerated depreciation methods. This loss would

be substantial and immediately would close off this source of funds for vital service improvements.

(a). The issues presented impact all public utility companies, including electric public utility companies as well as telephone and telegraph public utility companies.

Due to the substantial and continuous increase in the demand for public utility services, especially in the electric public utility industry, the investment by public utility companies in new plant and equipment in recent years has been enormous. The investment tax credits generated by such investments have resulted in huge federal income tax savings. Likewise, the tax deferrals obtained from the use of accelerated methods of depreciating such new plant and equipment have been very significant. As these savings and deferrals have come in recent years, many public utility companies, electric and otherwise, have very large deferred tax reserves representing tax benefits incurred in federal income tax years still open for the assessment of deficiencies. Should such taxes now become payable, rather than deferred or saved, the public utility companies involved would find it virtually impossible to pay the federal income taxes and perform their legal duty to serve the public.

Public utility companies have a legal duty to provide the public with adequate and efficient service. This duty is absolute. The public utility must render service to anyone within the public utility's service area requesting such service, provided that the customer is willing to pay for such service and to comply with the reasonable rules and regulations prescribed and approved by the appropriate regulatory authorities and provided that the utility has the capacity to render such service.

A lack of capacity to render requested service does not, however, excuse a public utility which has failed to build

and improve facilities required to meet the demand for service. A lack of capacity to render requested service is itself a violation of the legal duty of the utility to project the future demand for its services and to build adequate facilities to serve that demand.

The absolute legal duty of a public utility to serve the public is, in the jurisdictions in which the affiliates of The Southern Company operate, derived both from statute and common law. For example, Alabama Power Company, whose service area is in the State of Alabama, is subject to the legal duty set forth in *Code of Alabama 1975*, Section 37-1-49, as follows:

> Every utility shall maintain its plant, facilities and equipment in good operating condition and shall set up and maintain proper reserves for renewals, replacements and reasonable contingencies. Every utility shall render adequate service to the public and shall make such reasonable improvements, extensions and enlargements of its plants, facilities and equipment as may be necessary to meet the growth and demand of the territory which it is under the duty to serve.

The common law duty of a public utility has been expressed by the Supreme Court of Alabama, for example, as follows:

> A public utility is obligated to serve all members of the public that it holds itself out to serve, fairly and without discrimination. . .
>
> This duty to serve the public exists independent of statute regulating the manner in which such utilities do business. . . The duty is imposed because they are organized to do a business affected with a public interest and are held out to the public as being willing to serve all of its members. . . *Miller v. Hillview Water Works Project, Inc.*, 273 Ala. 267, 271, 139 So.2d 337 (1962).

Similar statutory provisions and common law concepts govern the affairs of all of The Southern Company operating affiliates and, indeed, all public utilities.

It is important to understand the legal duty a public utility discharges in providing its service because the existence of that duty dictates the actions a public utility must take if it loses the use of accelerated depreciation methods and the investment tax credit.

The investment tax credit results in a federal income tax savings which inures to the benefit of the public utility and its customers. When federal income tax is not due because of the application of the investment tax credit the funds otherwise needed for taxes become available to the public utility to pay for the facilities needed to meet the demand for public utility services. Since the public utility is under an absolute legal duty to provide the service demanded and to project and build the facilities required to meet that demand, if the funds generated by the investment tax credit are not available to assist in paying for the facilities, the utility's only alternative is to attempt to acquire the funds elsewhere. But, while the funds provided by the investment tax credit are free of cost to the utility, the replacement funds obtained elsewhere are expensive.

The public utility must turn to raising funds by issuing securities or by incurring debt. The purchasers of securities issued to supply funds must receive a return on their investment and the lenders of debt must be paid interest. The customers of the public utility ultimately bear the cost of such investment.

The use of accelerated methods of depreciation for federal income tax purposes results in a delay in the time at which the taxpayer must remit tax to the Federal Government. The same amount of tax liability to the Federal

Government will be incurred whether the taxpayer uses an accelerated method of depreciation or a straight line method of depreciation. The public utility and hence its customers will pay the tax in either event; the only difference (but a tremendous one) is whether the public utility will have the use of the funds during the period of the deferral or whether the Federal Government will have the funds during the period of the deferral.

When the public utility is allowed to have the use of such funds, as Congress intended, it uses the funds to construct and improve the facilities demanded by the service requirements — the facilities it has a legal duty to provide. If the utility is denied this source of funds it must turn to other sources of funds and, as discussed above, all of the other sources are expensive. The utility must borrow funds or issue securities, and to do so must pay for the use of the funds obtained. The utility's customers, again, ultimately bear the economic burden of acquiring the use of the funds.

The great value of the use of accelerated methods of depreciation and the investment tax credit to The Southern Company's affiliates and their customers can be seen in a comparison of (1) the amount of funds generated by those items, with (2) the gross property additions of the operating affiliates, and with (3) the total amount of funds acquired from major sources of internally generated funds. For the three year period 1975 through 1977, The Southern Company's consolidated experience was approximately as follows:

(Thousands of Dollars)

YEAR	*1975*	*1976*	*1977*
Funds generated by accumulated deferred income taxes	56,363	52,394	75,155
Funds generated by accumulated deferred investment tax credits	75,530	41,566	74,165
Total funds generated	131,893	93,960	149,320
Gross property additions	992,087	994,839	1,218,404
Percentage of gross property additions generated by accelerated depreciation methods and investment tax credit	13%	9%	12%
Total major sources of internally generated funds (includes deferred taxes, depreciation, investment tax credit, and retained earnings-does not include borrowings and securities issued)	472,024	393,984	554,848
Percentage of major sources of internally generated funds which came from accelerated depreciation methods and investment tax credit	28%	24%	27%

The value of such tax credits and deferred taxes to The Southern Company affiliates and their customers is the total dollar amount of the investment tax credit and the replacement cost of the funds deferred by accelerated methods of

depreciation. These dollars represent a substantial part of The Southern Company's sources of funds and the sources of funds of all public utility companies. The Southern Company is greatly concerned that these important sources of funds be protected. If these sources of funds are lost then, at best, The Southern Company operating affiliates will obtain the required funds elsewhere at a higher cost to their customers; at worst, and very likely, they will *not* be able to replace the lost funds and, as a result, will not be able to construct the facilities needed to meet the demand of the public for electricity.

The Internal Revenue Code provisions and the Treasury Regulations involved in the present case are clear and unambiguous with respect to the accounting methods a taxpayer must employ for ratemaking and financial reporting purposes to normalize the effects of the use of accelerated depreciation methods and the investment tax credit for federal income tax purposes. This Court, by issuing writs of certiorari to the Supreme Court of the State of California and subsequently sustaining the validity of the Treasury Regulations and the conclusions of the Internal Revenue Service interpreting the Internal Revenue Code and Regulations, can set down a durable standard to be followed by regulatory agencies, state courts and public utilities. This standard, once established, should deter additional tampering by regulatory agencies and state courts with the clear principles of normalization set out therein and should remove the cloud of uncertainty and pending financial disaster which hangs over the Petitioners, and which so swiftly could hang over the financial stability and viability of any public utility which has the need to avail itself of such tax practices.

(b). The issues presented are likewise of critical importance to many public utilities which employed accel-

erated depreciation methods prior to the Tax Reform Act of 1969, as well as those which, like the Petitioners, have used accelerated depreciation only since 1969.

The Petitioners, for federal income tax purposes prior to 1969, employed straight line, rather than accelerated, depreciation methods. As pointed out by the Petitioners, Section 167(l) of the Internal Revenue Code requires that companies such as the Petitioners, which had not before 1969 used accelerated depreciation or formally applied for permission to do so, cannot switch to accelerated depreciation unless they use the normalization method of accounting for ratemaking purposes.

The Southern Company wishes to point out to this Court that public utilities, such as the operating affiliates of The Southern Company, which used accelerated depreciation with normalization prior to 1969 are equally affected by the issues presented as are Petitioners. Section 167(l) of the Internal Revenue Code requires that companies such as The Southern Company operating affiliates that before 1969 had used accelerated depreciation methods for federal income tax purposes and used the normalization method of accounting for ratemaking purposes must continue to use the normalization method of accounting for ratemaking purposes if they are to remain eligible to use accelerated depreciation methods for federal income tax purposes. The only public utilities which are not affected by the depreciation issue presented in this case are those which prior to 1969 used accelerated depreciation methods for federal income tax purposes and for ratemaking purposes flowed through the federal income tax deferral generated by accelerated depreciation. The Southern Company urges this Court to consider the fact that many public utilities used accelerated depreciation prior to the 1969 and used a normalization method of accounting for the tax deferral for

ratemaking and financial accounting purposes. The issues presented in this case therefore are important to The Southern Company and its operating affiliates and many other similarly situated public utilities which did not come lately to the conclusion that accelerated depreciation methods offered benefits to their system, but instead have employed accelerated depreciation with the approval of their regulators for many years.

(c). The issues presented to this Court affect public utility companies whose rates are established using methods differing substantially from those employed by the California Commission.

The rates of The Southern Company operating affiliates are approved by state regulatory commissions that do not employ the ratemaking methods used by the California Commission. Indeed, there are differences among the several methods employed by the respective state commissions regulating the operating affiliates of The Southern Company. However, this case will affect The Southern Company operating affiliates and other public utility companies, without regard to the differences in the methods of establishing rates.

The Southern Company desires to point out to this Court that the issues presented in this case do not arise due to a peculiarity in the California Commission's approach to ratemaking which has no application to public utilities in other states and in the business of providing other services. The flaws in the California Commission's approach can be employed in other ratemaking methods and, therefore, this case is important to all such public utility companies.

(d). The issues presented must be resolved by this Court if the Petitioners' rights under the United States Constitution are to be protected, and The Southern Com-

pany operating affiliates and other public utilities may be adversely affected if this Court determines not to hear this case.

The Petitioners are faced with action by the Internal Revenue Service determining that they are not eligible for the investment tax credit in their tax years open for assessment and disallowing their use of accelerated depreciation methods retroactively in all years in which their rates for service are established with reference to the California Commission's erroneous method of "normalization". Should the California Commission's order become effective, the Internal Revenue Service undoubtedly will make huge deficiency assessments against the Petitioners and the Petitioners should be expected to contest those assessments and seek judicial determinations of the propriety of the "normalization" methods employed by the California Commission.

If the judicial review of the California Commission's "normalization" methods could take place under circumstances which would allow the California Commission to correct its error if error is found, then the California Commission could adjust the Petitioners rates after the judicial review of the Internal Revenue Service determinations and allow them to earn revenues to pay the increased taxes occasioned by the loss of the investment tax credit and to earn sufficient revenues to bear the cost of obtaining the funds needed to replace those lost through reporting federal income tax using straight line depreciation methods rather than accelerated depreciation methods. This is not possible in the present case. The California Commission is not permitted retroactively to adjust the Petitioners' rates if the present order becomes effective.

The Southern Company operating affiliates and other public utilities may be adversely affected by the situation

that has been created by the California Commission and the Supreme Court of the State of California and which will continue if this Court refuses to hear this case. Public utility rates are an issue in many states and regulatory commissions across this nation are under tremendous pressure to devise means of lowering rates. This case is attracting nationwide attention and, coupled with the conspicuous position of the California Commission in this field, is likely to stimulate other regulatory commissions to follow the exploits of the California Commission. The California Commission has held that it has found a way to require a public utility to use accelerated depreciation methods and the investment tax credit and, at the same time, reduce rates by flowing through part of the tax benefit and savings to current customers. Despite the fact that the Internal Revenue Service has ruled that the California Commission's invention does not work, other regulatory commissions may declare the law to be uncertain and seize on the contrived uncertainty as an excuse to justify requiring public utilities to reduce rates without regard to the disastrous consequences that will follow to the public utility and its customers. Any public utility subjected to such abuse would accumulate huge federal income tax deficiencies, and the existence of those deficiencies would impair its ability to finance the potential tax liability and to acquire the funds needed to construct and maintain the facilities it must have to meet its legal duty to serve the public.

Therefore, if the Petitioners are to be afforded an adjudication of their rights under the United States Constitution at a time when those rights can be effectively protected if found to be in danger of violation, then such determination of the Petitioners' rights must come from this Court in response to the issues presented in their petitions. Without such action of this Court, public utility companies across

the nation, including The Southern Company group, will be similarly exposed to regulatory actions creating tremendous liabilities with no available means of meeting them.

WHEREFORE, The Southern Company respectfully suggests that the public interest will be best served if this Honorable Court grants the Petitions for Writ of Certiorari presented herein.

Respectfully submitted,

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Respondents.

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,
vs.
THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,
Respondents.

MOTION OF SIERRA PACIFIC POWER COMPANY FOR LEAVE TO FILE BRIEF AMICUS CURIAE
and
BRIEF AMICUS CURIAE

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MOTION OF SIERRA PACIFIC POWER COMPANY FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Pursuant to Rule 42(1) of the Rules of this Court, Sierra Pacific Power Company respectfully moves the Court for leave to file the accompanying brief amicus curiae in sup-

port of the petitions for writ of certiorari. Counsel for Pacific Telephone & Telegraph Company and counsel for General Telephone Company of California have given consent and encouraged Sierra Pacific's participation. Counsel for the respondents has concluded that respondents should withhold consent.

Interest of Sierra Pacific Power Company

Sierra Pacific Power Company is directly and seriously affected by the order of the Public Utilities Commission Decision No. 87838 (September 17, 1977) which is the subject of the petitions for writ of certiorari in the above-entitled proceedings. It is a public utility based in Nevada. It provides electrical service both in Nevada and California. The rates that it may charge its California customers are set by the Public Utilities Commission of California. All of the electricity used to supply California customers is generated in Nevada, and the California Commission, in calculating the utility's cost of providing its California electrical service, uses the company's system-wide costs for producing electricity and allocates approximately fourteen percent of those costs to California.

In Sierra Pacific's most recent rate case, the Commission, in Decision No. 88337, (January 17, 1978), instructed its staff to apply to Sierra Pacific the very rate making methods that were imposed on Pacific Telephone & Telegraph Company and General Telephone Company of California in Decision No. 87838 (September 17, 1977), which decision

is the subject of the petitions for writ of certiorari by Pacific and General. The Staff was to produce the necessary calculations at a later hearing. Meanwhile Sierra Pacific's entire rate increase was to be held subject to refund. In the subsequent Decision No. 88644 (March 21, 1978) the Commission made clear that the final rate treatment for Sierra Pacific would depend upon the outcome of the Pacific-General Telephone litigation before this Court.

The Public Utilities Commission has made it clear that it will be guided by the outcome of the Pacific and General proceedings in this Court in determining appropriate rates for Sierra Pacific.

In its brief, Sierra Pacific will emphasize that the questions presented to this Court by Pacific and General are of direct concern not only to the two telephone companies but also to other utilities in California since the latter can expect to see the rate making methods that have been applied to Pacific and General applied to them as well.

Sierra Pacific will also point out that the interpretation of Sections 167(l) and 46(f) of the Internal Revenue Code, (the tax provisions at issue in these cases), is of vital concern to public utilities commissions throughout the country that are trying to accommodate their rate making methods to the restrictions imposed by federal tax law. Finally, Sierra Pacific points to the need for a speedy resolution of these issues in this Court and demonstrates the inadequacy of any other method of resolving these issues. These matters have not been sufficiently developed by Petitioners.

For these reasons, this Motion for Leave to File a Brief as Amicus Curiae should be granted.

Respectfully submitted,

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The Public Utilities Commission of the State of California, et al.,
Respondents.

BRIEF OF AMICUS CURIAE IN SUPPORT OF PETITIONS FOR CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

Sierra Pacific Power Company (Sierra Pacific) respectfully urges this Court to grant the petitions of Pacific Telephone & Telegraph Company and General Telephone Company of California for writ of certiorari to the Supreme Court of the State of California in the above-entitled proceedings.

The matter of concern is a rate order (Joint Appendix, Appendix B*) of the California Public Utilities Commission (the Commission) which the California Supreme Court, acting without opinion, declined to upset (Justice Richardson dissenting).

Primarily at issue is the correct interpretation of certain provisions in the Internal Revenue Code relating to accelerated depreciation and investment tax credit. Consequences of tremendous magnitude depend upon securing that correct and definitive interpretation from this Court. The petitioning telephone companies argue, and Sierra Pacific agrees, that the California Commission erred in concluding that its average annual adjustment (AAA) rate treatment of accelerated depreciation qualifies as "normalization" within the meaning of the Internal Revenue Code and that its annual adjustment (AA) rate treatment of investment tax credit qualifies as "ratable flow-through" within the meaning of that Code.

The California Commission recognized that if it is wrong in its interpretation, and such interpretation goes uncorrected, the tax benefits of accelerated depreciation and investment tax credit will be irretrievably lost by operation of the Internal Revenue Code. The California Commission made a determination that these benefits must be preserved. Joint Appendix, 11A-14A, 22A, 23A, 47A. The position of the Commission, in effect, is that while it thinks its interpretation of the Code is right, it needs to be sure, since

*The references in this brief to Joint Appendix are to the "Joint Appendix for Petitioners" filed with this Court by Petitioners with their petitions for writ of certiorari.

otherwise very large amounts of additional tax would be owing to the U.S. Government which California ratepayers would ultimately have to make up. Joint Appendix, 22A.

The following quotation from two of the concurring commissioners shows that it is of vital concern to the Commission itself to know whether its AAA and AA methods make the telephone companies eligible to use accelerated depreciation and investment tax credit, respectively. These two commissioners state in their concurring opinion, in a self-reassuring observation:

> "We have . . . protected eligibility . . ."

They then go on to say:

> "No one, however, should be confused on the latter point. The *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be." Joint Appendix 70A.

Set forth below are the reasons why a definitive resolution by this Court is important not only to California but to the nation.

I.

THE ISSUES RAISED IN THE PACIFIC AND GENERAL PETITIONS ARE OF NATIONAL IMPORTANCE

The present decision is the latest move in a battle of conflicting objectives between state governments, on the one hand, and the federal government, on the other. The battle has been waged with almost religious fanaticism for nearly two decades. No sooner had Congress enacted the Revenue

Code of 1954 allowing the use of accelerated depreciation for tax purposes than a dispute began over proper rate treatment. Commissions across the country, including the California Commission, convinced themselves one by one that the immediate tax benefit arising from accelerated depreciation was a permanent saving, and they thereby justified a flow-through for rate purposes of the lower tax in the early years of a property's life. Congressional history, on the other hand, showed that Congress had intended accelerated depreciation to provide a stimulus to the economy by providing to utilities and other businesses interest-free funds for capital expansion.

A simiiar fight was waged soon after Congress had created the tax benefit of investment tax credit. Should that benefit be flowed through to ratepayers, or should it be retained by the utility as a reflection of Congressional policy to stimulate the economy?

By 1969 about half of the states had adopted flow-through ratemaking and more were threatening to go in the same direction, tempted by the prospect of using federal tax dollars, in effect, to subsidize utility rates. Congress in that year acted to prevent any further defections to flow-through by enacting Section 167(l) of the Internal Revenue Code. This provision allows utilities that were not already subject to flow-through ratemaking when the section was enacted, to take accelerated depreciation in computing their tax liability, but only if the regulatory body uses "normalization" in computing taxes for rate purposes. In 1972, Congress enacted a similar provision, now Section 46(f) of the Internal Revenue Code, to prevent the benefits of investment tax credit from being used to subsidize utility rates. Under that section eligibility for the credit can be maintained only if "ratable. flow-through" is applied by the regulatory body in fixing rates. "Ratable flow-through" means flowing the investment tax credit through no more rapidly than ratably over the period for which depreciation expense is recognized on the property which produced the credit.

Congress cannot of course force states to make rates according to any given formula, nor can state commissions force Congress to enact tax provisions to their specifications. Rate-fixing is the prerogative of the state commission, and Congress cannot dictate in that area. Congress, on the other hand, has a legitimate interest in seeing to it that the objectives of its tax laws be attained and not aborted.

Sections 167(l) and 46(f) reflect an accommodation between state and federal interests. The states are free to set rates in any manner they choose consistent with due process. However accelerated depreciation will not be allowed for computing federal tax liability unless the state commission applies "normalization" to depreciation in computing tax expense for rate purposes, and investment tax credit will not be allowed for computing federal tax liability unless the state commission applies "ratable flow-through" to such credit for rate purposes.

California, and other state regulatory commissions, consider it to be their duty to flow-through to the ratepayers as much of the tax benefits as possible consistent with preserving eligibility. Congress on the other hand, created the

tax benefits to stimulate the economy by providing interest-free capital, not to subsidize ratepayers.

In the present situation where the objectives of the state and federal governments are at variance, and where the line of demarcation depends upon the correct construction of a federal statute, resolution of the problem should be undertaken by this Court. It is precisely the kind of question for which this Court was created. In the present circumstances, no other court can perform that function. If this Court denies certiorari, the Commission's order will go into effect, and, the telephone companies will, we believe, be required to pay back a vast tax liability of over one billion dollars, representing the tax benefits that were taken while this dispute over rate making was being litigated, because eligibility will have been lost for the open tax years.

It is true that the Tax Court or the federal district courts could ultimately interpret Sections 167(l) and 46(f) in tax litigation, but at what an absurd cost. To use the words of the opinion of the California Commission (Joint Appendix 22A) the utilities would have incurred "staggering financial problems to be ultimately borne by the ratepayers" on account of a tax liability that neither the telephone companies, the Commission nor the Congress believes should be incurred.

The tax liability at stake in this proceeding has grown to enormous proportions because there has been no definitive determination, along the way, of the federal questions raised in this case. The Commission has expected, indeed ordered the telephone companies to take accelerated depreciation and investment tax credit for tax purposes, but the Commission has had no authoritative court guidance defining

whether a particular rate treatment would meet the requirements for eligibility. The Commission has acted in the dark. It is time for this Court to settle the matter.

The same dreadful process experienced by the telephone companies is already underway for Sierra Pacific. Since January of this year Sierra Pacific's rates have remained open to adjustment while the Commission decides whether or not to adopt the AAA and AA methods for Sierra Pacific.

Another aspect of the importance of obtaining a definitive ruling by this Court lies in the fact that without such ruling, bizarre questions arise on the proper division of tax burdens to utility ratepayers when the utility operates in more than one state and is subjected to regulation by commissions in different states.

Sierra Pacific's situation is illustrative. It is regulated by the California Commission and the Nevada Public Service Commission. If an order of the California Commission disqualifies Sierra Pacific from taking accelerated depreciation, there is likely to be an adverse impact on the Company's ability to raise capital which will be felt both in Nevada and California. In such case California should increase Sierra Pacific's California rates so that Nevada ratepayers will not have to suffer because of the utility's increased cost of money. Just how much more California ratepayers should pay is an area in which there is likely to be bitter dispute between Nevada and California.

The importance of having an immediate and authoritative resolution of the correct interpretation of the limitations upon rate making to maintain eligibility for the tax

benefits is not confined to California. Commissions across the nation tend to pursue the same thought processes, and the California Commission has been a recognized leader. This Court's acceptance of the present case will prevent a recurrence of the agonizing situation in which the telephone companies, and indeed Sierra Pacific, find themselves.

CONCLUSION

For the reasons stated, certiorari should be granted. The interest of Sierra Pacific in this matter is indicated hereinabove and is set forth in its Motion for Leave to File this Brief as Amicus Curiae.

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November 10, 1978.

CERTIFICATE OF SERVICE

I, BORIS H. LAKUSTA, a member of the Bar of the Supreme Court of the United States and Counsel of Record for Sierra Pacific Power Company, Amicus Curiae, hereby certify that on November 8, 1978, pursuant to Rule 33, Rules of the Supreme Court, I served three copies of the attached Motion of Sierra Pacific Power Company for Leave to File Brief Amicus Curiae and Brief Amicus Curiae by placing the copies in an envelope addressed to each of the following persons:

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The envelope was then sealed, postage fully prepaid thereon, and thereafter was deposited in the United States mail on November 8 1978, at San Francisco, California.

All parties required to be served have been served.
Dated: November 8, 1978

BORIS H. LAKUSTA
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San Francisco, CA 94111

IN THE

Supreme Court of the United States

October Term, 1978
No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *et al.,*
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of the State of California.

Motion for Leave to File Amicus Curiae Brief and Amicus Curiae Brief of Communications Workers of America in Support of the Petition for Writ of Certiorari.

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SUBJECT INDEX

IN THE

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Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of the State of California.

Motion of Communications Workers of America for Leave to File Amicus Curiae Brief.

Communications Workers of America, AFL-CIO ("CWA"), a National Labor Organization within the meaning of the National Labor Relations Act, respectfully moves this Court for leave to file the *amicus curiae* brief annexed hereto.

1. Standing and Interest.

CWA is the exclusive collective bargaining agent for 55,439 employees of the Pacific Telephone and Telegraph Company.

2. Timing of This Application.

On or about October 10, 1978, CWA received a copy of the Petition for Writ of Certiorari filed herein by the petitioner and since that time has studied the arguments therein set forth.

3. Point to Be Argued.

CWA believes there is a necessity for additional argument on the following point.

THE COMMISSION'S DECISION WILL NEGATIVELY AFFECT EMPLOYMENT IN THE STATE OF CALIFORNIA.

4. Summary of Argument and Scope Thereof.

Pacific mentions fleetingly the effect of the PUC decision on its work force.

As *amicus curiae*, CWA would collect for the Court the evidence presented herein that the loss of eligibility and the payment of back taxes plus interest and rate refunds to customers would force Pacific to lay off approximately 12,500 employees and to reduce its construction budget by more than 50%. Further, there was testimony concerning the "ripple effect" this would have on other California industries and the significant consequences to employment in the State.

As *amicus curiae*, CWA would urge through argument and precedent that the PUC could not foreclose advance ruling from the IRS in view of the economic impact of the decision.

As *amicus curiae*, CWA proposes that it could cover this subject matter in a brief not to exceed 30 pages in length.

For the reasons stated above and in the annexed brief, CWA requests leave to file its *amicus curiae* brief in support of the Petition for Writ of Certiorari.

Respectfully submitted,

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Attorneys for Communications Workers of America, AFL-CIO.

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Amicus Curiae Brief of Communications Workers of America in Support of the Petition for Writ of Certiorari.

Introduction.

1. CWA is the exclusive collective bargaining representative for 55,439 employees of Pacific Telephone and Telegraph Company ("Pacific").

2. CWA, in behalf of those employees and in its own behalf, with leave of Court, files this *amicus curiae* brief in support of the Petition for Writ of Certiorari and in opposition to the 3 to 2 opinion in Decision No. 87838 rendered by the Public Utilities Commission of the State of California ("PUC" or "the Commission").

3. In summary of its position herein CWA urges that the Commission erred in rendering a decision

based merely upon its analysis of the federal tax laws when the Commission knew that an incorrect analysis would have far-reaching harmful consequences (a) in the quality of service to ratepayers and customers and (b) in its economic effect upon employment in the State of California.

CWA POSITION.

I

The Commission's Failure to Deal With or Make Findings Upon the Possible Loss of Tax Eligibility Renders Its Decision an Arbitrary Violation of Due Process.

Pacific's Treasurer, Mr. Joses, established the financial problems stemming from loss of eligibility. He established that loss of eligibility would result in a two hundred sixteen million dollar shortfall for the next year's construction budget. He noted the foreclosure of public money markets, the harsh terms of private lending; the cost of repayments. (Exhibit 9, pp. 26-31.)

From the standpoint of CWA, all of the foregoing merges in one statement made by Mr. Joses at page 32:

> "The [work] force is estimated at 82,571 [people] at the end of 1977, a decline of 13.3% from our present estimate. That means 12,634 employees would have to be laid off which is an extremely serious matter."

Indeed.

Much more is said by Mr. Pollard (Exhibit 11) about decline in the quality of service which would be occasioned by loss of eligibility.

> "Slow dial tone . . . no circuits available and equipment failures . . . held orders . . . [use of] worn or obsolete equipment . . . [customers] up in arms over the sorry state of affairs."

The degradation of service would of course be bad. Urbanized Californians would become discommoded and irritable because of this bad service. But the irritation of the innocent customer is nothing as against the helplessness of the disemployed worker.

The court will note that the telephone business is unlike other businesses. The mechanic laid off at Lockheed can always go to work for Rockwell. Such people have saleable skills. The craftsperson laid off at Pacific or General is a telephone craftsperson. We can't tell 12,634 such craftspeople to go to work for some other telephone company in the State of California.

The Court's attention is also directed to the identity of the laid-off employee.

To reduce its work force by 12,500 people "would require laying off employees with as much as six years of service." (Exhibit 11, p. 11.)

Interested groups appeared before the PUC suspecting it would be their members who would be the first to go. (Decision, Pacific's Appendix, p. 16.) The Los Angeles Urban League spoke on behalf of blacks and other minorities. The NAACP sought a decision which would preserve the employment of ethnic minorities and aid unemployed blacks. Los Padrinos cautioned the effect loss of eligibility would have upon Spanish surnamed employees. The Pacific Women's Affirmative Action organization appealed for preserved eligibility

so as to enable Pacific to achieve its affirmative action goals relating to women.

Pollard testified that, based on recent hiring practice, more than half of the laid-off workers would be women, more than one-third would be ethnic minorities. (Transcript, p. 508.) This apparently assumes a "last hired first fired" approach which may or may not be in compliance with Title VII and/or the Bell System consent decree, collective bargaining obligations, or either, or both.

CWA represents all of the employees of Pacific and General; whatever the ethnic or sex identity of the disaffected 12,500 employees, they will be people taken out of the bargaining unit and out of work.

In addition to these employees directly affected, Mr. Pollard spoke euphemistically about a "ripple effect" which would result in 2,400 lost Western Electric jobs in California and 4,700 lost Western Electric jobs elsewhere. (Exhibit 11, p. 10; figures modified at Transcript, p. 486, lines 3-6.)

It is possible then, that 20,000 jobs will be lost if eligibility is lost, that the morale of a presently efficient work force will be destroyed, and that instantaneous telephone communication will be confined to emergency situations. This possibility, according to the testimony, looms large if eligibility is lost.

No witnesses were called in rebuttal of this testimony. Cross-examination was uneventful. The testimony stands.

The Commission listened to this testimony and, with perhaps a touch of sarcasm, it characterized such testimony as "a service and employment scenario of horrendous proportions." (Decision, p. 35.) The Commission foresaw:

> ". . . no meaningful change in the operations and quality of service, number of employees, levels of earnings, impairment of financial integrity, or other deleterious consequences as predicted by Pacific." (Decision, p. 35.)

The reasoning of the Commission concludes "no meaningful change" because "the [tax] eligibility of both companies is unaffected" and then adds the key words "*in our judgment.*" (Decision, p. 35.)

We know now that the PUC's critical judgment was wrong. That error undermines the validity of the decision and brings the adverse economic impact a giant step closer.

The Commission disregards the testimony of Pacific's financial witnesses. CWA would also like to disregard these testimonial predictions, but the potential firing of 20,000 employees requires assurance of the soundest kind. Such assurances are missing from the record.

There are only two conceivable reasons why the PUC rejected the predictions. Both are hinted at in the Decision, but neither is the subject of a finding.

In the first paragraph of page 35, the PUC suggests that Pacific ably absorbed a $176 million refund and a $90 million rate reduction in 1972-73 with no appreciable harm. At pages 36-37, the Commission looks at Pacific's successful handling of the 1972-73 problem and with rare bravado says, "If this be confiscation, let there be more of the same." That remark is somewhat more swashbuckling than typical of regulatory agencies.

Of course, the very figures used by the Commission for comparison purposes at page 35 total nine hundred million dollars against two hundred sixty million in 1972-73. The comparison is disparate and the Commission's conclusion does not follow. (See Pollard's testimony at Transcript, pp. 487-488.)

Notwithstanding, the Commission in this part of its Decision, seems reliant on the managerial ability of Pacific. "They did it before, they can do it again." Precious little comfort is taken from that belief, however, in view of the fact that everywhere else the Decision is honeycombed with criticism of Pacific's managerial abilities. So, for example, at page 9, the Commission labels Management as "intransigent" and "deplores" its decision making. At page 13, it assumes" Pacific's "imprudent Management." At page 41, the Commission excoriates Management for failure to previously seek an advisory IRS ruling. At page 47, the PUC expressly finds Management "imprudent."

CWA finds no assurance that Management could handle with elan a one billion dollar shortfall.

The second potential reason for the PUC's "no meaningful change" remark is similarly without support. We know that from the opinion already received from the IRS.

Twenty thousand jobs may well depend upon the accuracy of the Commission's tax analysis. Were the tax ramifications relatively clear-cut, perhaps those 20,000 workers would be reassured of their future. However, in the Commission's own words:

> "We have here a case of first impression under the tax laws . . ." (Decision, p. 41.)

The Commission has inaccurately predicted the likely response of the IRS and further presumes the reaction of the U.S. Supreme Court to a matter of first impression. It is so sure of its prediction that it is willing to and does gamble one billion Pacific dollars, continued good service, and 20,000 jobs on the outcome. That prediction is beyond mere arbitrariness. In the words of Commissioner Symons, it is a "reckless" decision. In the words of Commissioner Sturgeon, it is a "cavalier" decision. (See dissents.) Either lie outside the bounds of due process.

Respectfully submitted,

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In the

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No. 78-606

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THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, AND ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, AND WILLIAM SYMONS, JR., THE MEMBERS OF SAID PUBLIC UTILITIES COMMISSION, ET AL.,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF OF DALLAS POWER & LIGHT COMPANY, TEXAS ELECTRIC SERVICE COMPANY AND TEXAS POWER & LIGHT COMPANY AS AMICI CURIAE IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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November 8, 1978

In the

Supreme Court of the United States

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Petitioner,

v.

The Public Utilities Commission of The State of California, and Robert Batinovich, Vernon L. Sturgeon, Richard D. Gravelle, Claire T. Dedrick, and William Symons, Jr., The Members of said Public Utilities Commission, et al.,
Respondents.

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MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF

In accordance with Rule 42 of the Supreme Court of the United States, Dallas Power & Light Company, Texas Electric Service Company and Texas Power & Light Company respectfully file this motion for leave to file the accompanying amicus curiae brief. Petitioner has given consent to its filing. The Cities of Los Angeles, San Diego and San Francisco have refused to consent; the other Respondents have failed to reply to requests for consent.

INTEREST OF AMICI CURIAE

Dallas Power & Light Company, Texas Electric Service Company and Texas Power & Light Company are the operating companies in the Texas Utilities Company System. Together they serve approximately one-third of the people and one-third of the area of the State of Texas with electric energy. They are subject to regulation by municipalities which they serve and by the Public Utility Commission of Texas.

The issues in this case are of nationwide importance. While in no sense does the Public Utilities Commission of the State of California have jurisdiction over these Companies, regulatory procedures and processes of the various jurisdictions, particularly one of the importance of California, are viewed and considered in all jurisdictions. On the other hand, obviously the Internal Revenue Code and Regulations under it, their interpretation, construction and enforcement, are important to all.

The dilemma which the Petitioner faces in this situation is, therefore, of direct concern to these Companies, involving as it does a conflict of interpretation of federal law between the Internal Revenue Service and the California Commission — a conflict which the Supreme Court of California has refused to consider or review.

Petitioner is not in a position to present the facts and circumstances which these Companies face. Petitioner knows its own problems; it cannot adequately present the scope and breadth of the problems which other utility companies will encounter if relief is not granted.

The Public Utility Commission of Texas, though quite conscious of its obligation to represent the interests of rate

payers, has followed regulatory practices in issuing rate orders which recognize the thrust of the accelerated depreciation and investment tax credit provisions of the Internal Revenue Code and permit companies subject to its jurisdiction to receive the benefits of these provisions. Yet, if the decision of the California Commission is allowed to stand, unaffected, the risk is substantial that the Texas Commission and other regulatory bodies will feel impelled, in behalf of rate payers, to follow procedures similar to those adopted in California. The consequences then to other companies will be as dire as those facing Petitioner.

In 1978 Dallas Power & Light Company, Texas Electric Service Company and Texas Power & Light Company had estimated Deferred Federal Income Taxes — Liberalized Depreciation and Investment Tax Credit items totalling nearly \$136,000,000. Similar amounts for 1979 are estimated in excess of \$131,000,000. In addition, the tax credits taken from 1975 through 1977 inclusive (open years for federal income tax limitation purposes) amount to over \$116,000,000. These sums are also in jeopardy as to these Companies.

CONCLUSION

It is for these reasons that these Companies ask for leave to file their amicus curiae brief in support of the petition for writ of certiorari.

Respectfully submitted,

....

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Respondents.

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AMICUS CURIAE BRIEF IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

INTEREST OF AMICI CURIAE

Their interest has been set forth in the foregoing motion for leave to file brief.

ARGUMENT

I. THERE IS A CONFLICT UNDER THE SUPREMACY CLAUSE OF ARTICLE VI OF THE CONSTITUTION BETWEEN THE CALIFORNIA DECISION AND THE FEDERAL POSITION AS REPRESENTED BY THE INTERNAL REVENUE CODE, THE REGULATIONS, AND THE INTERNAL REVENUE SERVICE RULINGS.

It would be redundant to repeat or paraphrase the statement of Petitioner, which is adopted by reference. It sets forth clearly the conflict which has developed between the California Commission, supported by the Supreme Court of

California,[1] on the one hand, and the position on a federal question taken by the body authorized to administer the federal income tax laws, namely, the Internal Revenue Service, on the other hand.

This is not a situation where a state body has chosen to pass up benefits which it had the option to decline. There is no requirement that a state commission must follow regulatory procedures which would permit a utility to take accelerated depreciation or receive the advantages of investment tax credits. California was free to follow such regulatory procedures as it wished (provided, of course, it considered the impact thereof on the utilities concerned and observed due process standards); but this it did not do. The California Commission has insisted that it has followed the mandates of the Internal Revenue Code and has formulated its own interpretation of the pertinent sections. Such interpretation is squarely in conflict with the rulings of the Internal Revenue Service.

This will not do. The area in which the California Commission attempts to operate — the position it takes — is in the federal domain and in such a question of state-federal conflict, the federal position must prevail, under the supremacy clause of Article VI of the Constitution.

This is a federal controversy of California's making. California has said to Petitioner: "We recognize in this rate-making process that you are entitled to these federal tax

[1] See its decisions in *City and County of San Francisco v. Public Utilities Commission*, 6 Cal.3d 119, 490 P.2d 798 (1971); *City of Los Angeles v. Public Utilities Commission*, 7 Cal.3d 331 (1972); *City of Los Angeles v. Public Utilities Commission*, 15 Cal.3d 680, 542 P.2d 1371 (1975); and its final judgment in this cause (APP.A, p. 1A). The concurring opinion of two Commissioners in the California decision states that: "The entity most responsible for the result of the order as it stands is the Court, which clearly mandated us to achieve a balance between utility and ratepayer which we have finally done."

benefits. We will set your rates on the assumption that you receive them and we are seeing to it that you do so. The federal statute means so and so and that is the basis on which we are proceeding."

But the Internal Revenue Service reads the statute differently — and Petitioner is caught in the middle.

Thus there is here a classic case of state-federal conflict, where the state recognizes the litigant's federal rights but misconstrues them. This Court is the arbiter that must decide the matter. Compare what is said in *St. Louis, Iron Mountain, & Southern Railway Co. v. Taylor*, 210 U.S. 281 (1908) at page 293:

> Where a party to litigation in a state court insists, by way of objection to or requests for instructions, upon a construction of a statute of the United States which will lead, or, on possible findings of fact from the evidence may lead, to a judgment in his favor, and his claim in this respect, being duly set up, is denied by the highest court of the state, then the question thus raised may be reviewed in this court. The plain reason is that, in all such cases, he has claimed in the state court a right or immunity under a law of the United States and it has been denied to him. Jurisdiction so clearly warranted by the Constitution and so explicitly conferred by the act of Congress needs no justification. But it may not be out of place to say that in no other manner can a uniform construction of the statute laws of the United States be secured, so that they shall have the same meaning and effect in all the states of the Union.

II. THE CALIFORNIA COMMISSION DECISION AND ITS EFFECT UPON PETITIONER CONSTITUTE A VIOLATION OF THE DUE PROCESS CLAUSE OF THE FOURTEENTH AMENDMENT.

The California Commission, in issuing its decision, proceeded upon the assumption that Petitioner was entitled

to the benefits of the accelerated depreciation and investment tax provisions of the Internal Revenue Code. It based its rate structures upon this assumption while at the same time inserting provisions which made it impossible for Petitioner to receive these benefits. The Commission gave Petitioner no advance opportunity to apply for a ruling from the IRS and refused to join in Petitioner's subsequent application. It said that the adverse decisions of the Internal Revenue Service when ultimately received added "nothing new" and refused to reconsider. The Supreme Court of California has declined to review the matter.

Under these circumstances there has been an arbitrary and capricious denial of due process. There is a complete absence of the "rudiments of fair play." *West Ohio Gas Co. v. Public Utility Commission of Ohio (No. 1)*, 294 U.S. 63, 71 (1935). Where can Petitioner turn except to this Court? The California Commission will give no relief; the Supreme Court of California will take no action; yet Petitioner is faced with a Commission decision which, unless reviewed and set aside by this Court, will have the gravest financial consequences to Petitioner.

CONCLUSION

It is respectfully submitted that for the foregoing reasons the writ of certiorari should be granted.

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CERTIFICATE OF SERVICE

The undersigned attorney for Dallas Power & Light Company, Texas Electric Service Company and Texas Power & Light Company hereby certifies that three copies of the foregoing Motion for Leave to File Amicus Curiae Brief and Brief were served today upon all counsel of record in this cause by mailing the same to them at their post office addresses with first class postage affixed.

JOS. IRION WORSHAM

Attorney for Dallas Power & Light Company, Texas Electric Service Company and Texas Power & Light Company.

ATTORNEY FOR AMICI CURIAE

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1978

Nos. 78-606 and 78-607

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, *Petitioner*,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said PUBLIC UTILITIES COMMISSION, et al., *Respondents*.

GENERAL TELEPHONE COMPANY OF CALIFORNIA, *Petitioner*,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al., *Respondents*.

MOTIONS OF SIERRA PACIFIC POWER COMPANY, KANSAS CITY POWER & LIGHT COMPANY, AND UTAH POWER & LIGHT COMPANY FOR LEAVE TO FILE BRIEF AMICI CURIAE and BRIEF AMICI CURIAE

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November 17, 1978

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October Term, 1978

Nos. 78-606 and 78-607

The Pacific Telephone and Telegraph Company,
Petitioner,

vs.

The Public Utilities Commission of the State of California, and Robert Batinovich, Vernon L. Sturgeon, Richard D. Gravelle, Claire T. Dedrick, and William Symons, Jr., the members of said Public Utilities Commission, et al.,
Respondents.

General Telephone Company of California,
Petitioner,

vs.

The Public Utilities Commission of the State of California, et al.,
Respondents.

MOTIONS OF SIERRA PACIFIC POWER COMPANY, KANSAS CITY POWER & LIGHT COMPANY, AND UTAH POWER & LIGHT COMPANY FOR LEAVE TO FILE BRIEF AMICI CURIAE

Pursuant to Rule 42(1) of the Rules of this Court, Sierra Pacific Power Company (Sierra Pacific), Kansas City Power & Light Company (KCPL), and Utah Power & Light Company (Utah Power) respectfully move the Court for leave to file the accompanying brief amici curiae in support of the petitions for writ of certiorari. Counsel for

Pacific Telephone & Telegraph Company and counsel for General Telephone Company of California have given consent and encouraged Sierra Pacific's, KCPL's and Utah Power's participation. Counsel for the respondents have concluded that respondents should withhold consent.

Interest of Sierra Pacific Power Company, Kansas City Power & Light Company, and Utah Power & Light Company.

Sierra Pacific Power Company stands to be directly and gravely affected by the order of the Public Utilities Commission Decision No. 87838 (September 17, 1977) which is the subject of the petitions for writ of certiorari in the above-entitled proceedings. It is a public utility based in Nevada. It provides electrical service both in Nevada and California. The rates that it may charge its California customers are set by the Public Utilities Commission of California. All of the electricity used to supply California customers is generated in Nevada. The California Commission, in calculating the utility's cost of providing its California electrical service, takes the company's systemwide costs for producing electricity and allocates approximately fourteen percent of those costs to California.

In Sierra Pacific's most recent rate case, the Commission, in Decision No. 88337, (January 17, 1978), instructed its staff to apply to Sierra Pacific the same rate making methods for determining tax expense that were imposed on Pacific Telephone & Telegraph Company and General Telephone Company of California in Decision No. 87838 (September 17, 1977), which decision is the subject of the present petitions for writ of certiorari by Pacific and General. The staff was to produce the necessary calculations at a later hearing. Meanwhile Sierra Pacific's entire rate increase was to be held subject to refund. In a subsequent Decision No. 88644 (March 21, 1978) the Commission reaffirmed that it intended to apply the same rate treatment for Sierra Pacific as for Pacific and General, provided it (the Commission) succeeded before this Court in the present matter.

Kansas City Power & Light Company (KCPL) is a public utility that provides electricity in Kansas and Missouri. Its rates are regulated by the Kansas State Corporation Commission and by the Missouri Public Service Commission. Pursuant to the Internal Revenue Code the bulk of its income tax expense is determined for rate purposes by normalizing the effect of accelerated amortization and liberalized depreciation, and by using ratable flow-through for investment tax credit. Its rates presently in effect are set both in Kansas and Missouri using the methods of ratemaking that are consistent with Sections 167(l) and 46(f) of the Internal Revenue Code; however, there is pending before the Missouri Commission a rate proceeding in which one of the issues is whether to alter the ratemaking methods currently used to determine tax expense.

Utah Power & Light Company is a public utility which provides electric service in most of Utah and in portions of the adjoining states of Idaho and Wyoming. Its rates are regulated by the respective regulatory commissions in the states where it serves, specifically by the Utah Public Service Commission, the Idaho Public Utilities Commission, and the Wyoming Public Service Commission. Its sales for resale are regulated by the Federal Energy Regulatory Commission.

Pursuant to the Internal Revenue Code the bulk of Utah Power's tax expense for rate purposes is determined by normalizing the effect of accelerated amortization and liberalized depreciation, and by using ratable flow-through for investment tax credit. Its rates presently in effect are set by the four regulatory commissions named above, and each of those commissions is using the methods of rate-making provided for in Sections 167(l) and 46(f) which preserve eligibility for the tax benefits noted.

It is of paramount importance to the three amici curiae and their ratepayers that these benefits be preserved. If the California Commission's decision under attack is allowed to stand, there is grave danger that ratemaking bodies throughout the nation will be tempted to adopt the California rate-making methods, and that tax benefits will be lost as a result. If the benefits enjoyed by amici curiae are lost there will be an adverse impact on their cash flow position resulting from the increased tax liability and a corresponding deterioration in financial stability. Also of serious impact to these utilities and their customers is that the disallowance of the investment tax credit would deprive the utilities and their customers of the benefits of the credit now passed on to them during the life of the associated investment. The result inevitably would be higher costs to the ratepayers. Therefore, an authoritative opinion by this Court respecting the proper construction to be placed upon the Internal Revenue Code is of utmost importance.

The attached brief amici curiae emphasizes that the questions presented to this Court by Pacific and General are of direct concern not only to the two telephone companies but also to other utilities in California, since the latter can expect to see the rate making methods that have been applied to Pacific and General applied to them as well.

The attached brief also emphasizes that the correct interpretation of Sections 167(l) and 46(f) of the Internal Revenue Code, is of vital concern to public utilities commissions throughout the country that are trying to accommodate their rate making methods to the restrictions imposed by federal tax law.

The attached brief points to the need for a speedy resolution of the issues in this Court and demonstrates the inadequacy of any other method of resolving the issues. This aspect has not been developed by Petitioners to the extent deemed desirable by the moving parties herein.

For these reasons, this Motion for Leave to File a Brief as Amici Curiae should be granted.

Respectfully submitted,

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November 17, 1978

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1978

Nos. 78-606 and 78-607

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said PUBLIC UTILITIES COMMISSION, et al.,
Respondents.

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,
Respondents.

BRIEF OF AMICI CURIAE IN SUPPORT OF PETITIONS FOR CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

Sierra Pacific Power Company (Sierra Pacific), Kansas City Power & Light Company (KCPL), and Utah Power & Light Company (Utah Power) respectfully urge this Court to grant the petitions of Pacific Telephone & Tele-

graph Company and General Telephone Company of California for writ of certiorari to the Supreme Court of the State of California in the above-entitled proceedings.

The matter of concern is a rate order (Joint Appendix, Appendix B*) of the California Public Utilities Commission (the Commission) which the California Supreme Court, acting without opinion, declined to upset (Justice Richardson dissenting).

Primarily at issue is the correct interpretation of certain provisions in the Internal Revenue Code relating to accelerated depreciation and investment tax credit. Consequences of tremendous magnitude depend upon securing that correct and definitive interpretation from this Court. The petitioning telephone companies argue, correctly, it is submitted, that the California Commission erred in concluding that its average annual adjustment (AAA) rate treatment of accelerated depreciation qualifies as "normalization" within the meaning of the Internal Revenue Code and that its annual adjustment (AA) rate treatment of investment tax credit qualifies as "ratable flow-through" within the meaning of that Code.

The California Commission recognized that if it is wrong in its interpretation, and such interpretation goes uncorrected, the tax benefits of accelerated depreciation and investment tax credit will be irretrievably lost by operation of the Internal Revenue Code. The California Commission made a determination that these benefits must be preserved. Joint Appendix, 11-A-14A, 22A, 23A, 4¶A. The position of the Commission, in effect, is that while it thinks its inter-

*The references in this brief to Joint Appendix are to the "Joint Appendix for Petitioners" filed with this Court by Petitioners with their petitions for writ of certiorari.

pretation of the Code is right, it needs to be sure, since otherwise very large amounts of additional tax would be owing to the U.S. Government which California ratepayers would ultimately have to make up. Joint Appendix, 22A.

The following quotation from two of the concurring commissioners shows that it is of vital concern to the Commission itself to know whether its AAA and AA methods make the telephone companies eligible to use accelerated depreciation and investment tax credit, respectively. These two commissioners state in their concurring opinion, in a self-reassuring observation:

> "We have . . . protected eligibility . . ."

They then go on to say:

> "No one, however, should be confused on the latter point. The *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be." Joint Appendix 70A.

Set forth below are the reasons why a definitive resolution by this Court is important not only to California but to the nation.

I.

THE ISSUES RAISED IN THE PACIFIC AND GENERAL PETITIONS ARE OF NATIONAL IMPORTANCE.

The present decision is the latest move in a battle of conflicting objectives between state governments, on the one hand, and the federal government, on the other. The battle has been waged with almost religious fanaticism for nearly

two decades. No sooner had Congress enacted the Revenue Code of 1954 allowing the use of accelerated depreciation for tax purposes than a dispute began over proper rate treatment. Commissions across the country, including the California Commission, convinced themselves one by one that the immediate tax benefit arising from accelerated depreciation was a permanent saving, and they thereby justified a flow-through for rate purposes of the lower tax in the early years of a property's life. Congressional history, on the other hand, showed that Congress had intended accelerated depreciation to provide a stimulus to the economy by providing to utilities and other businesses interest-free funds for capital expansion.

A similar fight was waged soon after Congress had created the tax benefit of investment tax credit. Should that benefit be flowed through to ratepayers, or should it be retained by the utility as a reflection of Congressional policy to stimulate the economy?

By 1969 about half of the states had adopted flow-through ratemaking and more were threatening to go in the same direction, tempted by the prospect of using federal tax dollars, in effect, to subsidize utility rates. Congress in that year acted to prevent any further defections to flow-through by enacting Section 167(l) of the Internal Revenue Code. This provision allows utilities that were not already subject to flow-through ratemaking when the section was enacted to take accelerated depreciation in computing their tax liability, but only if the regulatory body uses "normalization" in computing taxes for rate purposes. In 1972, Congress enacted a similar provision, now Section 46(f) of the Internal Revenue Code, to prevent the benefits of invest-

ment tax credit from being used to subsidize utility rates. Under that section eligibility for the credit can be maintained only if "ratable flow-through" is applied by the regulatory body in fixing rates. "Ratable flow-through" means flowing the investment tax credit through no more rapidly than ratably over the period for which depreciation expense is recognized on the property which produced the credit.

Congress cannot of course force states to make rates according to any given formula, nor can state commissions force Congress to enact tax provisions to their specifications. Rate-fixing is the prerogative of the state commission, and Congress cannot dictate in that area. Congress, on the other hand, has a legitimate interest in seeing to it that the objectives of its tax laws be attained and not aborted.

Sections 167(l) and 46(f) reflect an accommodation between state and federal interests. The states are free to set rates in any manner they choose consistent with due process. However accelerated depreciation will not be allowed for computing federal tax liability unless the regulatory commission applies "normalization" to depreciation in computing tax expense for rate purposes, and investment tax credit will not be allowed for computing federal tax liability unless the regulatory commission applies "ratable flow-through" to such credit for rate purposes.

California, and other state regulatory commissions, consider it to be their duty to flow-through to the ratepayers as much of the tax benefits as possible consistent with preserving eligibility. Congress on the other hand, created the tax benefits to stimulate the economy by providing interest-free capital, not to subsidize ratepayers.

In the present situation where the objectives of the state and federal governments are at variance, and where the line of demarcation depends upon the correct construction of a federal statute, resolution of the problem should be undertaken by this Court. It is precisely the kind of question for which this Court was created. In the present circumstances, no other court can perform that function. If this Court denies certiorari, the Commission's order will go into effect, and, the telephone companies will, we believe, be required to pay back a vast tax liability of over one billion dollars, representing the tax benefits that were taken while this dispute over rate making was being litigated, because eligibility will have been lost for the open tax years.

It is true that the Tax Court or the federal district courts could ultimately interpret Sections 167(l) and 46(f) in tax litigation, but at what an absurd cost. To use the words of the opinion of the California Commission (Joint Appendix 22A) the utilities would have incurred "staggering financial problems to be ultimately borne by the ratepayers" on account of a tax liability that neither the telephone companies, the Commission nor the Congress believes should be incurred.

The tax liability at stake in this proceeding has grown to enormous proportions because there has been no definitive determination, along the way, of the federal questions raised in this case. The Commission has expected, indeed ordered the telephone companies to take accelerated depreciation and investment tax credit for tax purposes, but the Commission has had no authoritative court guidance defining whether a particular rate treatment would meet

the requirements for eligibility. The Commission has acted in the dark. It is time for this Court to settle the matter.

The same dreadful process experienced by the telephone companies is already underway for Sierra Pacific, and could potentially extend to other utilities, both in California and in other jurisdictions. Since January of this year Sierra Pacific's rates have remained open to adjustment while the Commission decides whether or not to adopt the AAA and AA methods for Sierra Pacific.

Another aspect of the importance of obtaining a definitive ruling by this Court lies in the fact that without such ruling, bizarre questions arise on the proper division of tax burdens to utility ratepayers when the utility operates in more than one state and is subjected to regulation by commissions in different states.

Sierra Pacific's situation is illustrative. It is regulated by the California Commission and the Nevada Public Service Commission. If an order of the California Commission disqualifies Sierra Pacific from taking accelerated depreciation, there is likely to be an adverse impact on the Company's ability to raise capital, which will be felt both in Nevada and California. In such case California should increase Sierra Pacific's California rates so that Nevada ratepayers will not have to suffer because of the utility's increased cost of money. Just how much more California ratepayers should pay is an area in which there is likely to be bitter dispute between Nevada and California.

The importance of having an immediate and authoritative resolution of the correct interpretation of the limitations upon rate making to maintain eligibility for the tax

benefits is not confined to California. Commissions across the nation tend to pursue the same thought processes, and the California Commission has been a recognized leader. This Court's acceptance of the present case will prevent a recurrence of the agonizing situation in which the telephone companies, and indeed Sierra Pacific, find themselves.

CONCLUSION

For the reasons stated, certiorari should be granted. The interest of Sierra Pacific, KCPL and Utah Power in this matter is indicated hereinabove and is set forth in their Motion for Leave to File this Brief as Amici Curiae.

Respectfully submitted,

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November 17, 1978

CERTIFICATE OF SERVICE

I, BORIS H. LAKUSTA, a member of the Bar of the Supreme Court of the United States and Counsel of Record for Sierra Pacific Power Company, Kansas City Power & Light Company, and Utah Power & Light Company, Amici Curiae, hereby certify that on November 17, 1978, pursuant to Rule 33, Rules of the Supreme Court, I served three copies of the attached Motion of Sierra Pacific Power Company, Kansas City Power & Light Company, and Utah Power & Light Company for Leave to File Brief Amici Curiae and Brief Amici Curiae by placing the copies in an envelope addressed to each of the following persons:

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The envelope was then sealed, postage fully prepaid thereon, and thereafter was deposited in the United States mail on November 17, 1978, at San Francisco, California,

All parties required to be served have been served.

Dated: November 17, 1978.

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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,
v.
THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said PUBLIC UTILITIES COMMISSION, ET AL.,
Respondents.

No. 78-607

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,
v.
THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

Motion of California Independent Telephone Association for Leave to File Brief Amicus Curiae

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In the Supreme Court of the United States

October Term, 1978

No. 78-606

The Pacific Telephone and Telegraph Company,
Petitioner,
v.

The Public Utilities Commission of the State of California, and Robert Batinovich, Vernon L. Sturgeon, Richard D. Gravelle, Claire T. Dedrick, and William Symons, Jr., the members of said Public Utilities Commission, Et Al.,
Respondents.

No. 78-607

General Telephone Company of California,
Petitioner,
v.

The Public Utilities Commission of the State of California, Et Al.,
Respondents.

Motion of California Independent Telephone Association for Leave to File Brief Amicus Curiae

California Independent Telephone Association respectfully moves the Court pursuant to its Rule 42(1) for leave to file the accompanying brief *amicus curiae* in support of the petitions for writs of certiorari filed by Pacific Tele-

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said PUBLIC UTILITIES COMMISSION, ET AL.,
Respondents.

No. 78-607

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

Brief of Amicus Curiae in Support of Petitions for Certiorari to the Supreme Court of the State of California

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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,
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THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said PUBLIC UTILITIES COMMISSION, ET AL.,
Respondents.

No. 78-607

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,
v.
THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

Brief of Amicus Curiae in Support of Petitions for Certiorari to the Supreme Court of the State of California

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With this brief *amicus curiae* the California Independent Telephone Association (CITA) hopes to demonstrate to the Court that the issues presented by the instant petitions for writs of certiorari are of importance not only to the

parties but to utilities and their customers throughout California and the nation.

CITA represents twenty-five independent telephone companies which provide service to millions of Californians. The action taken in these cases by the California Public Utilities Commission (CPUC), unless reversed, can ultimately frustrate the efforts of CITA's members to provide quality service at the lowest possible rates. The order of the CPUC which is the subject of these proceedings is binding precedent in California and authority elsewhere for depriving utilities large and small of very significant tax benefits in the name of lower utility rates. Once these tax benefits are lost, however, the only means of satisfying the resulting increased tax liability is through higher rates to utility customers.

CITA hereby adopts the brief *amicus curiae* filed today by Sierra Pacific Power Company. That brief further demonstrates the impact on all utilities of the issues presented by these cases and the absence of any means of resolving these important questions other than review by this Court.

CITA therefore respectfully urges the Court to grant the requested writs of certiorari.

DATED: November 10, 1978.

Respectfully submitted,

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In the Supreme Court of the United States

October Term, 1978

Nos. 78-606, 78-607

The Pacific Telephone and Telegraph Company,
Petitioner,

v.

The Public Utilities Commission of the State of California, et al.,
Respondents,

General Telephone Company of California,
Petitioner,

v.

The Public Utilities Commission of the State of California, et al.,
Respondents.

OBJECTION TO MOTIONS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

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In the Supreme Court of the United States

October Term, 1978

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v.
The Public Utilities Commission of the State of California, et al.,
Respondents,

General Telephone Company of California,
Petitioner,
v.
The Public Utilities Commission of the State of California, et al.,
Respondents.

OBJECTION TO MOTIONS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

The City and County of San Francisco, the City of Los Angeles, and the City of San Diego (Cities) are parties respondent in Nos. 78-606 and 78-607.

The Cities to date have received requests to file a brief *amicus curiae* from the Edison Electric Institute (EEI), The Southern Company (Southern), the Sierra Pacific Power Company (Sierra Pacific), Dallas Power & Light Company, Texas Electric Service Company and Texas Power & Light Company.[1] The Cities denied consent to these entities and will deny consent to any

1. On November 6, 1978 the Cities received a Motion and Brief in 78-607 of the Communication Workers of America (CWA). Consent was never requested by CWA. This motion should be denied due to its lack of timeliness, failure to show a substantial interest and failure to add any material beyond petitioners allegations. On November 7, 1978 CWA submitted a similar document in 78-606. On November 7, 1978 Kansas City Power and Light requested consent.

other entity making a request. In this filing, the Cities will explain, pursuant to Rule 42(3), the basis for our denial of consent and request the Court to Deny the Motions to file a Brief *amicus curiae* of EEI and Southern Company.

As of November 7, 1978, the City had not received copies of a Motion or Brief from Sierra Pacific, Dallas Power & Light Company, Texas Electric Service Company and Texas Power & Light Company. If these entities or any other entities file motions and briefs they should be rejected on grounds that they were not submitted "in a reasonable time prior to the considera-tion . . . of the petition" (Rule 42(1)), in addition to the reasons to be stated relevant to EEI and the Southern Company. We do not object to the timeliness of the EEI and Southern motions. These motions should be rejected on the following bases.

Movants Lack Requisite Interest in Proceedings.

The petitioners in 78-606 and 78-607 seek Supreme Court review of a narrow California intrastate rate refund and reduction order. The order is based on the California Public Utilities Commission's (PUC) and the California Supreme Court's findings of managerial imprudence and obstinancy in selection of income tax alternatives. *City and County of San Francisco* v. *Public Utilities Commission* 6 Cal.3d 119, 127-130 (1971); *City of Los Angeles* v. *Public Utilities Commission* 15 Cal.3d 680, 689, fn. 12 (1975), PUC Decision No. 87838, Finding 1, Petitioners' Appendix B, p. 45A.

EEI does not allege its members are equally imprudent or obstinate. Even assuming that the facts in the instant cases are applicable to EEI members, the opinions subject of the petitions are intrastate rate making orders. The views of the PUC, as affirmed by the California Supreme Court, are not binding on any other state or, federal regulatory agency. The methodology adopted in the instant case based on the imprudence of Pacific and General is not even binding in future cases involving petitioners. *City of Los Angeles* v. *Public Utilities Commission* 15 Cal.3d 680, 704, fn. 42. (1975) In these circumstances EEI has not shown the requisite interest to justify the filing of an amicus curiae brief.[2]

Southern implicitly recognizes it has no specific interest in the issues raised by the Petitions. Southern is not concerned with California rate standards (see Southern Brief p. 21) or even in an advisory tax opinion based on the facts relevant to Pacific and General. Southern is concerned about "public utilities which both before and after the enactment of the Tax Reform Act of 1969 used accelerated depreciation methods for federal income tax purposes and normalized the deferred taxes for ratemaking purposes; . . . "and to public utilities whose state regulatory commissions use ratemaking methods different from those employed by the California Commission." (Southern Motion pp. 4-5.) These circumstances are not applicable to the facts in the instant action.

EEI and Southern lack an interest in the factual and legal issues of the instant petitions.

Movants Briefs Add No Relevant Contribution to the Disposition of the Petitions

The EEI Brief virtually repeats the arguments raised by Pacific and paraphrases them. EEI has failed

2. EEI is purportedly presenting the views of its member electric utility companies. We believe that Southern, Sierra Pacific, Dallas Power & Light, Texas Electric Service and Texas Power & Light are EEI members. If these entities have a specific interest it could be represented by filing a brief of their own or through EEI. They should not be represented by two briefs. (EEI and the individual company.)

to "set forth facts or questions of law that have not been or reasons for believing they will not adequately be presented by the parties." (Rule 42(3)

The Southern brief presents no analysis of the facts or law relevant to the petitions. Its only legal citation is Alabama intrastate rate criteria (Southern Brief at 15).

The EEI and Southern briefs merely clog the record in the instant proceedings. There is no allegation that Pacific and/or General are not adequately represented by counsel or able to present issues adequately to the Court.

CONCLUSION

All motions to file a brief *amicus curiae* should be denied. Under Court Rule 42(1) "Such motions are not favored." The instant motions are particularly defective due to lack of movants' interest in the proceedings and lack of relevant substantive comment in the briefs.

Respectfully submitted,
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Nos. 78-606 and 78-607

In the Supreme Court of the United States

OCTOBER TERM, 1978

PACIFIC TELEPHONE AND TELEGRAPH COMPANY, PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.

GENERAL TELEPHONE COMPANY OF CALIFORNIA, PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-606

PACIFIC TELEPHONE AND TELEGRAPH COMPANY, PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.

No. 78-607

GENERAL TELEPHONE COMPANY OF CALIFORNIA, PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

QUESTION PRESENTED

The United States will discuss the following question:

Whether the California Public Utilities Commission erred in holding that its ratemaking orders preserved petitioners' eligibility for the investment credit and accelerated depreciation for federal income tax purposes under Sections 46(f) and 167(*l*) of the Internal Revenue Code of 1954.

INTEREST OF THE UNITED STATES

In 1969 and 1971, Congress enacted Sections 167(*l*) and 46(f) of the Internal Revenue Code of 1954, respectively, which deal with the eligibility of regulated public utilities for accelerated depreciation and the investment credit. Section 167(*l*) provides that a regulated public utility that had not previously claimed the benefits of accelerated depreciation could not do so unless it used the "normalization method of accounting" for ratemaking purposes. The use of such a method of accounting insures that the benefits of the utility's depreciation deductions will be allocated equally between its present and future customers. Section 46(f) similarly places certain limits upon eligibility for the investment tax credit. With respect to petitioners, Section 46(f)(2) permits the credit only on the condition that they reflect that credit in their cost of service for ratemaking purposes no faster than ratably over the useful life of their property.

In these cases, the California Public Utilities Commission issued ratemaking orders based on methods of accounting that it concluded would "maintain the eligibility of the utilities to use accelerated depreciation and ITC [investment tax credit] and comply with the requirements of the Internal Revenue Code relating to [petitioners]" (J. App. B, 49A-50A).[1] However, the Internal Revenue Service has ruled that the Commission's assumption was erroneous and that methods of accounting it required would in fact destroy petitioners' eligibility because they do not provide for normalization (in the case of depreciation) or an allowable ratable reduction (in the case of the investment tax credit) (J. App. D, 95A-131A; J. App. E, 133A-142A).

As the official charged with the responsibility of administering and enforcing the federal income tax statute, the Secretary of the Treasury agrees with petitioners that the interpretation of the Internal Revenue Code by the California Public Utilities Commission, upheld by the court below, requires review by this Court at this time in order to put to rest uncertainty as to a fundamental issue potentially affecting the tax liabilities of all regulated public utilities. If the decision below is correct, petitioners would be subject to the rate adjustments ordered by the Commission but would be eligible for the benefits of accelerated depreciation and the investment credit

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[1] "J. App." refers to the Joint Appendix filed on behalf of both petitioners.

that they have claimed. But as matters now stand, petitioners are simultaneously subject to the ratemaking orders of the Commission and the assertion of massive federal income tax deficiencies exceeding $1 billion in accordance with the Treasury's rulings. If this Court were to decline review and the Treasury's ruling position is ultimately sustained in a federal tax proceeding, petitioners would suffer the burden of lower rates (based on the assumption of eligibility for the federal tax benefits) and disallowance of those tax benefits. Moreover, if the California Public Utilities Commission's interpretation of Sections 167(*l*) and 46(f) remains unreviewed while the Treasury continues to adhere to its position, the decision below is likely to be followed by other state regulatory bodies to the detriment of similarly-situated public utilities. The United States believes that the continued existence of this conflict between the Treasury and the state regulatory commissions threatens to work an enormous hardship upon the public utilities sector of the economy and to disrupt the stability of the capital markets as affected utilities must undertake borrowings to meet these large-scale federal tax obligations.

STATEMENT

These state public utility ratemaking cases uniquely present legal questions that solely involve the proper interpretation of two federal tax statutes.

Section 167(*l*) of the Internal Revenue Code of 1954, which was enacted as part of the Tax Reform

Act of 1969, permits a regulated public utility to claim the benefits of accelerated depreciation if it had not previously done so on the condition that it use a "normalization method of accounting" for ratemaking purposes. Section 46(f) of the Code, which was enacted in 1971 as part of the restoration of the investment credit, similarly conditions a utility's eligibility for the credit upon the computation of its cost of service for ratemaking purposes by ratably reducing such cost by the tax credit amortized over the useful lives of its assets. By requiring normalization of depreciation and ratable accounting of the investment tax credit, Congress sought to avoid the loss of federal revenues that would otherwise occur if these tax benefits were immediately "flowed through" to the current ratepayers thereby resulting in reduced rates and reduced taxable income. See H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 172 (1969); H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 26 (1971); S. Rep. No. 92-553, 92d Cong., 1st Sess. 39 (1971).

In these proceedings, the California Public Utilities Commission was acutely conscious of the need to preserve petitioners' eligibility for accelerated depreciation and the investment credit. It stated (J. App. B, 22A):

> Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their rate-

payers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis.

The Commission thereupon took petitioners' accelerated depreciation into account pursuant to a method of accounting it characterized as the "averaged annual adjustment" (AAA method) (J. App. B, 25A). It "believe[d] [that its] method [was] direct, simple, and in full compliance with the applicable federal law" so that [e]ligibility [for accelerated depreciation] will be maintained * * *" (J. App. B, 27A). In taking the investment credit into account for ratemaking purposes, the Commission adopted a method that it believed "to encompass all the factors [it] desire[d]," which it characterized as "the annual adjustment" (2A method) (J. App. B, 30A).

Petitioners sought a continuation of the then-existing rates until such time as they could seek a ruling from the Internal Revenue Service as to whether the Commission's methods would preserve their eligibility for accelerated depreciation and the investment credit (J. App. B, 39A). Although the Commission acknowledged that "[w]e have here a

case of first impression under the tax laws" (J. App. B, 40A), it rejected petitioners' request for delay on the ground that "an advance ruling within a reasonable time [was] not probable" (*ibid.*). It therefore concluded that the AAA and 2A methods of accounting "maintain the eligibility of the utilities to use accelerated depreciation and ITC [investment tax credit] and comply with the requirements of the Internal Revenue Code relating to [petitioners]" (J. App. B, 49A-50A).

The Commission reached its decision by a 3-2 vote. Of the three members in the majority, two concurred noting that "[t]he *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be" (J. App. B, 70A; emphasis in original). The two dissenting members were of the view that the Commission should have allowed petitioners a reasonable period of time to obtain a ruling from the Internal Revenue Service. They concluded that it was "imprudent of the Commission not to exhaust available consultive procedures and thus safeguard the state against the catastrophic consequences of ineligibility" (J. App. B, 72A).

Less than three weeks after the Commission issued its order, petitioners sought rulings from the Internal Revenue Service as to their eligibility for accelerated depreciation and the investment credit under the AAA and 2A methods devised by the Commission. Nine and ten months later, the Internal Revenue

Service issued letter rulings to petitioners respectively concluding that the AAA method was not a normalization of accounting under Section 167(l) of the Internal Revenue Code (J. App. D, 95A-131A), and that the 2A method was inconsistent with the requirements of Section 46(f) of the Code (J. App. E, 133A-142A). Accordingly, the Service concluded that the Commission's order destroyed petitioners' eligibility for accelerated depreciation and the investment credit.

Upon reciept of the Internal Revenue Service's ruling with respect to accelerated depreciation, petitioners asked the Commission to join them in requesting the Supreme Court of California (where petitions for review had been filed) to remand the cases to the Commission in light of the Internal Revenue Service ruling. The Commission declined, stating that the ruling "adds nothing new to these proceedings" (78-607 Pet. 15).

The Supreme Court of California denied petitions for review.[2] One member of the court was of the opinion that the petition should have been granted (J. App. A, 1A-2A).[3]

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[2] Under California law, the California Supreme Court's order denying review was a decision on the merits. The jurisdiction of this Court is therefore properly invoked under 28 U.S.C. 1257(3). See *People* v. *Western Air Lines, Inc.*, 42 Cal.2d 621, 630, 268 P.2d 723, 728, appeal dismissed, 348 U.S. 859 (1954). See also *Napa Valley Electric Co.* v. *Railroad Commission*, 251 U.S. 366 (1920).

[3] The Internal Revenue Service's ruling with respect to petitioners' eligibility for the investment credit was issued on

DISCUSSION

These cases present federal tax questions of enormous potential fiscal significance to regulated public utilities that should be resolved by this Court.

1. In *FPC* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 459-461 (1973), this Court reviewed the background that led to the enactment of Section 441 of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 625, which added Section 167(l) to the Internal Revenue Code of 1954. Section 167, as originally enacted in 1954, permits a taxpayer to compute depreciation of its business assets either on a straight-line or accelerated basis. The straight-line method yields an equal annual depreciation allowance over the useful life of the asset. The accelerated or liberalized methods provide for depreciation allowances in the early years that are greater than the straight-line method but which steadily decrease over the useful life of the asset.

Federal income taxes are properly included as an expense by a regulated public utility in computing its cost of service for ratemaking purposes (see 411 U.S. at 460 n.2). As originally enacted in 1954, the Internal Revenue Code provided no rules governing the manner in which a public utility was to compute its federal tax expense for ratemaking purposes if it elected to use accelerated depreciation. Accordingly,

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July 27, 1978, two weeks after the California Supreme Court denied review of the Commission's orders in these cases (J. App. A, 1A-2A; J. App. E, 133A).

the regulatory commissions required utilities using accelerated depreciation for tax purposes to use the same method for calculating their cost of service and, thus, to "flow through" the resulting tax savings to their customers (*id.* at 460).

In 1969, Congress became concerned with the loss of tax revenues that resulted from the combined effect of accelerated depreciation (leading to higher tax deductions) and flow-through for fixing rates (leading to lower rates and therefore lower gross revenues). As a result, Congress added Section 167(*l*) to the Internal Revenue Code, which generally provides that utilities that had not previously used accelerated depreciation could not do so unless they used the "normalization method of accounting" for ratemaking purposes. Under the normalization method, a utility computes its cost of service as if it were using straight-line depreciation, and "must make adjustments to a reserve to reflect the deferral of taxes resulting from the use" on its tax return of an accelerated method of depreciation. Section 167(*l*)(3)(G), J. App. C, 82A-83A. In other words, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes is placed in a deferred tax reserve account. This method was designed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation and make the deferred taxes available to the utility for investment.

The statute is silent as to how the deferred tax reserve is to be treated for ratemaking purposes. Treasury Regulations, Section 1.167(*l*)-1(h)(6), J. App. C, 88A-93A, permits the reserve account to be excluded from the utility's base to which its rate of return is applied. The theory of this exclusion is that the amount of the deferred taxes is treated as an interest-free loan to the utility and that the utility is not entitled to a return on that part of its capital base that is not provided by its shareholders. However, Section 1.167(*l*)-1(h)(6)(i) of the Regulations is explicit as to the proper amount of the exclusion from the rate base. It provides that "a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(*l*) which is excluded from the base to which the taxpayer's rate of return is applied * * * exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking."

The Commission's AAA method of accounting runs afoul of this explicit prohibition of the Regulations. It does not limit the exclusion to the utility's deferred tax reserve in the test year, *i.e.*, the period used for computing the rate base and cost of service. To the contrary, the Commission's method provides for an exclusion from the rate base by the estimated average of the deferred tax reserve for the test year and the three succeeding years. Given the fact that peti-

tioners continue to make additions to their plant (see J. App. B, 58A-59A), the Commission's method unquestionably results in an exclusion that "exceeds the amount of [the] reserve for deferred taxes for the period used," *i.e.*, the test year. This is not a normalized method of accounting. See Treasury Regulations, Section 1.167(*l*)-1(h)(6)(iv), Ex. (1), J. App. C, 89A-90A. By hypothesizing a larger deferred tax reserve than in fact exists, the Commission has required a partial "flow through" of the tax deferral to the utilities' present customers in derogation of Congress' intent in enacting Section 167(*l*).

2. The Commission's 2A method of taking the investment credit into account also thwarts the congressional purpose of providing a tax incentive to modernize plants by prohibiting the pass-through of the credit to the utility's current ratepayers. Thus, Section 46(f) provides that no investment credit will be allowed with respect to any public utility property if (1) the utility's cost of service for ratemaking purposes is reduced by more than a ratable portion of the allowable credit over the useful life of the property or (2) the utility's rate base for ratemaking purposes is reduced by reason of any portion of the allowable credit (see J. App. C, 76A).

Here, the Commission's 2A method took a ratable portion of the investment credit into account in computing cost of service for the test year based upon projected capital additions. However, the Commission gave no recognition to the fact that if the utility has an increased credit based upon estimated capital additions for succeeding years, it necessarily also has increased depreciation expenses and an expanded rate base. By freezing petitioners' depreciation and rate base at test year levels but increasing the credit (and thereby reducing the cost of service) for succeeding years, the Commission has reduced the cost of service "by more than a ratable portion of the credit allowable" in contravention of Section 46(f)(2)(A). The result will be disallowance of petitioners' claimed investment tax credits.

3. In urging review of the decision below, we are not unmindful of the fact that this Court generally grants certiorari in federal tax cases only where there is a conflict of decisions. See, *e.g.*, opinion of Mr. Justice Stevens respecting the denial of the petition for certiorari in *Singleton* v. *Commissioner*, No. 78-78 (Oct. 30, 1978), slip op. 4. Here, the federal tax questions presented are concededly technical and have been addressed only by the decision below in a state ratemaking proceeding and by the Commissioner of Internal Revenue in private letter rulings to petitioners. Normally, these facts would call for further development of the questions by the federal courts prior to this Court's exercise of its discretionary review.

But these are unusual cases. As matters now stand, the decision below and the Internal Revenue Service are on a collision course that threatens the financial stability of all regulated public utilities in California and potentially affects other similarly-situated companies. If, as we submit, the decision below is based

on erroneous interpretations of the applicable federal tax law, a delay in establishing that fact with finality will result in the simultaneous subjection of the utilities to lower rates based upon the false assumption of eligibility for substantial tax benefits and the disallowance of those benefits. Thus, the resolution of the conflict between the decision below and the Internal Revenue Service cannot practicably await the outcome of the federal tax litigation with respect to the deficiencies that inevitably will ensue. A decision with such far-reaching impact upon a vital sector of the nation's economy calls for review by this Court.

CONCLUSION

The petitions for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 1978

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1978

No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE
STATE OF CALIFORNIA, and ROBERT BATINOVICH,
VERNON L. STURGEON, RICHARD D. GRAVELLE,
CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR.,
the members of said Public Utilities Commission, et al.,
Respondents.

No. 78-607

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA, ET AL.,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of the State of California

OBJECTION TO MOTIONS FOR LEAVE TO FILE A BRIEF AMICUS CURIAE AND TO MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

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In the Supreme Court

OF THE

United States

October Term, 1978

No. 78-606

The Pacific Telephone and Telegraph Company,
Petitioner,

vs.

The Public Utilities Commission of the
State of California, and Robert Batinovich,
Vernon L. Sturgeon, Richard D. Gravelle,
Claire T. Dedrick, and William Symons, Jr.,
the members of said Public Utilities Commission, et al.,
Respondents.

No. 78-607

General Telephone Company of California,
Petitioner,

vs.

The Public Utilities Commission of
the State of California, et al.,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of the State of California

OBJECTION TO MOTIONS FOR LEAVE TO FILE A BRIEF AMICUS CURIAE AND TO MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

The Respondent California Public Utilities Commission (Commission) has received copies of motions for leave to file a brief *amicus curiae* in one or both of these proceedings from Edison Electric Institute, Southern Company, Communications Workers of America, Sierra Pacific

Power Company, Kansas City Power & Light Company and the California Independent Telephone Association and a copy of the memorandum for the United States as *amicus curiae*.

Pursuant to Rule 42.3 the Commission hereby objects to the granting of said motions, and to any others which may yet be filed, for the following reasons:

1. The judgment below is one affecting only the two petitioners and is not binding upon a court of any other state nor upon any other regulatory commission. Therefore, it does not raise a federal question of national significance.

2. The Commission's ratemaking conclusions were made in direct response to a remand order of the California Supreme Court which had earlier found that it was an imprudent act for a utility not to adopt accelerated depreciation when available. (*City and County of San Francisco v. Public Utilities Commission,* 6 C.3d. 119, Resp. App. A at page 12 RA). Both petitioners herein had refused to do so prior to 1970.

   None of the movants claim to be in the same or a similar position as the petitioners in that respect. It is difficult to see how a decision founded on such a unique set of facts could be extended to other, out-of-state utilities. Therefore, the movants lack a real interest in these proceedings.

3. With repect to the memorandum for the United States, this was not timely filed. It was received by

the Commission on the day the Commission's own brief in opposition was filed with this Court.

   It was, therefore, not possible to respond thereto in that brief. However, that memorandum is an additional example of the inconsistent positions taken by federal agencies with respect to tax eligibility. Those inconsistencies are specified on pages 12, 13 and 14 of said brief in opposition. As such, the memorandum adds weight to the Commission's conclusion that all parties would benefit if this Court would hear and decide the issue of tax eligibility in favor of the Commission now.

CONCLUSION

The motions for leave to file a brief *amicus curiae* should be denied. The memorandum for the United States as *amicus curiae* should be rejected.

Respectfully submitted,

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1978
Nos. 78-606, 78-607

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,

Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,

Respondents,

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Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,

Respondents.

REPLY TO MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

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IN THE
SUPREME COURT OF THE UNITED STATES

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IN THE

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October Term, 1978

Nos. 78-606, 78-607

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,

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THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,

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Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,

Respondents.

REPLY TO MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

Respondents, the City and County of San Francisco, the City of Los Angeles, and the City of San Diego (Cities), on November 10, 1978, served their "Brief in Opposition to Petitions for Writ of Certiorari" in No. 78-606 and No. 78-607.

On November 13, 1978, the Cities received the "Memorandum for the United States as Amicus Curiae" (hereafter cited as Solicitor General's memo). The instant "Reply" is the first opportunity for the cities to respond to that document.

QUESTION PRESENTED

78-606: Petitioner Pacific Telephone and Telegraph Company (Pacific) contends at Pet. pages 2-3 that the rate making methods adopted by the PUC and approved by the California Surpeme Court are in violation of the Supremacy Clause of the United States Constitution and deprive Pacific of Fourteenth Amendment Rights.

78-607: Petitioner General Telephone Company of California (General), via footnote at page 2 of its Petition, adopts Pacific's Fourteenth Amendment argument, but did not adopt the Supremacy Clause argument. It asks the Court to issue an opinion on the question of whether the rate making methods adopted by the California Supreme Court will deprive General of its eligibility under the Internal Revenue

Code to continue the use of accelerated depreciation and the investment tax credit (JDIC).

The Solicitor General's Memo solely addresses itself to the eligibility question raised by General. Although nominally the memo is in response to the petitions in No. 78-606 and No. 78-607, the memo never discusses the questions raised in No. 78-606. The memo itself is clearly irrelevant to No. 78-606.

INTEREST OF THE UNITED STATES

This topic appears at pages 2-4 of the Solicitor General's memo. The Cities recognize that the United States has a significant interest in the instant proceedings. Agencies of the United States frequently appear before the California Public Utilities Commission (PUC). The United States is a major utility customer and like all other customers it has an interest in the rates adopted by the state agencies. It has a right (if not a duty to taxpayers) to insure it does not pay excessive rates.

With respect to the rate making treatment for accelerated depreciation, the attorneys representing the Administrator of General Services and the Secretary of Defense have appeared before the PUC on behalf of the consumer interests of all the executive agencies of the United States.[1/]

Although the United States does have a legitimate interest in the intrastate rate making questions before this Court, these interests are never even implicitly represented by the Solicitor General.

1/ The following filings are particularly relevant:

1. Answering Brief of the Administrator of General Services and the Secretary of Defense on Behalf of the Consumer Interests of All the Executive Agencies of the United States, Application No. 53587, December 26, 1973.

2. Supplemental Brief of the Secretary of Defense on Behalf of the Consumer Interests of the Executive Agencies of the United States, Application No. 53587, July 5, 1974.

3. Petition for Rehearing by Department of General Services, Application No. 53587, August 12, 1974.

The Solicitor General's memo solely represents the interests of the petitioner utilities. In the conclusion of the "Interest of the United States" section, at page 4, the Solicitor General expresses concern about a potential "enormous hardship upon the public utilities sector of the economy". At page 9, the Solicitor General makes it clear that his interest is not related to concerns of the federal government, but that the cases present questions of "enornous potential fiscal significance to regulated public utilities". The Solicitor General concludes his brief at page 13 by stating that "the financial stability of all regulated public utilities in California" is threatened.[2/]

The Solicitor General may have heartfelt concern for utilities such as Pacific

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2/ The fears expressed by the Solicitor General, in the instant case, are similar to those expressed by Pacific to the California and United States Supreme Court, respectively, in previous years. Each time these fears have been proven to be unfounded. (See Respondent's Breif in Opposition For Writ of Certiorari, at pp. 21-22.)

and General. This concern is not an interest of the United States.

The Cities cannot and will not present the position that should have been presented based on the bona fide interests of the United States. We will inform the Court what agencies of the United States have in fact told the PUC. We will contrast the statements by agencies of the United States, representing the interest of the United States, in briefs to the PUC with the position of the Solicitor General in his advocacy of the utilities' interests.

STATEMENT

The Solicitor General's "Statement", pages 4 through 8, begins with an erroneous assumption and retrogresses from that point. The "Statement" section commences at page 4, "These state public utility rate making cases uniquely present legal questions that solely involve the proper interpretation of two federal tax statutes."

The Cities, in their brief, have described at length the background of the cases before the Court. (Cities' Brief, pp. 3-9) The cases themselves involve intrastate rate making criteria under California law. No analysis of these cases could be made without specific analysis of the factual background and the California rate making criteria provided to the PUC by the California Supreme Court in City of San Francisco v. Public Utilities Commission 6 Cal.3d 119 (1971), R. App. A, 1 RA-16 RA, and City of Los Angeles v. Public Utilities Commission 15 Cal.3d 680 (1975), R. App. A, 16RA-51 RA. These cases will hereinafter be cited as San Francisco and Los Angeles II.

The Solicitor General fails to cite these cases anywhere in his memo. These cases make it apparent that because of imprudence and obstinancy of the utilities, rates could be set "notwithstanding changes in the federal tax statute." San Francisco at 11 RA. The PUC's decision was sustainable by the California Surpeme Court irrespective of the tax eligibility question. This point was argued in the Cities' brief at pages 11-13.

The Solicitor General's "Statement" is simply not relevant to the facts and the legal issues in the California cases. The Solicitor General carefully avoids any analysis of the factual and legal background of these cases. These omissions convert the Solicitor General's "Statement" into a misstatement and enable the Solicitor General to transform a narrow intrastate rate case into a broad federal tax case.

DISCUSSION

The Solicitor General's "Discussion" is in three parts: 1. Accelerated Depreciation, at pages 9-12. 2. Investment Tax Credit, at pages 12-13, and 3. Concluding plea on behalf of the utilities, at pages 13-14.

Accelerated Depreciation

The utilities seek ineligibility on the premise that the PUC has made an excessive rate base exclusion (General Pet., p. 12). The Solicitor General begins his discussion of the actual eligibility issue at page 11. His initial

statement at page 11 is correct: "The statute is silent as to how the deferred tax reserve is to be treated for rate making purposes." Recognition of this point should have led the Solicitor General to conclude that the rate base treatment of the reserve could not impair eligibility. If the Solicitor General had the slightest doubt, the statutory history makes it patently clear that there was no intent to predicate eligibility on rate base treatment. Relevant statutory history was cited at Cities' Brief, p. 19.

Attorneys representing the United States' interests have told the PUC, that eligibility could not be impacted by rate base treatment. "We vehemently dispute that Section 441 of the Act speaks at all to the subject of rate base computations" Answering Brief of the Administrator of General Services and the Secretary of Defense on Behalf of the Consumer Interests of All the Executive Agencies of the United States, Application No. 53587, December 26, 1973, at page 41. (GSA - Defense Brief)

The GSA - Defense Brief explained in detail that eligibility could not be predicated upon rate base treatment. The Brief, in its Attachment A at page 8, concluded that if the IRS adopted regulations that predicated eligibility upon rate base treatment such regulations would be "illegal".[3/]

After recognizing the lack of statutory authority to restrict rate making treatment at page 11, the Solicitor General concludes, "The Commission's AAA method of accounting runs afoul of this explicit prohibition of the Regulations." This is a factual error. The methodology adopted by the PUC specifically complies with the regulations of the IRS. The regulation cited by the Solicitor General at page 11 solely requires that there be a matching of the test year for purpose of tax reserve rate base deduction and tax expenses. The PUC has specifically followed this methodology.

3/ Attachment A of the GSA - Defense Brief is reprinted in full as Appendix A to this Reply (pages A-1 through A-8).

> "As a result of each of the deductions from rate base federal tax expense will be recomputed on the same basis in a test year for the test year and the three corresponding subsequent years, thus matching estimated tax deferral amount for each period with the estimated federal tax expense for the same period. This method complies with Treasury Regulation 1.167(1)-(1)(h)(6) and is normalization accounting." (Dec. 87838 Finding 3 P. App. B,45A thru 46A)

This methodology, which the Solicitor General questions in his brief, was specifically claimed to be consistent with the tax regulations in the Supplemental Brief of the Secretary of Defense on Behalf of the Consumer interests of Executive Agencies of the United States filed with the PUC on July 5, 1974.[4/] In analyzing the relevant regulations, the Secretary of Defense stated at page 5,

> "The period to be used to determine the deferred income tax reserve must only match the period used for determination of income tax expense, not the test period used for rate making purposes."

4/ The analysis at pp. 5-7 of the July 5, 1974 Brief is reprinted in Appendix B of this Reply (pages B-1 through B-4).

The PUC did not follow the recommendations of the Secretary of Defense when it issued Decision No. 83162. In response to that decision, the Cities filed a petition for rehearing. Among other points we challenged the fact that the rate making methodology adopted would result in a significant windfall to Pacific due to failure to properly take into account in rate base exclusion the normalization reserve. (Pet. Rehearing, pp. 5-7) On August 12, 1974, the Department of General Services filed a petition for rehearing and stated that it fully supported and adopted the joint petition for rehearing of the Cities.

The PUC, as it had so often in the past, rejected the arguments of the Cities and the federal government. The Cities again appealed to the Caliofrnia Supreme Court. For the third time, in Los Angeles II, a unanimous California Supreme Court annulled the accelerated depreciation portion of the decisions of the PUC.

In Decision No. 87838 (Pet.App.B), the PUC adopted a rate making method similar to that described by the Secretary of

Defense in Appendix B. This rate making method is consistent with IRS regulations and California rate criteria. It would be valid even if it did not conform to IRS regulations. The federal agencies, through their attorneys, told the PUC that IRS had no authority to predicate eligibility upon rate base treatment. (Rep. App. pp. A-1 thru A-8)

The Solicitor General's factual and legal analysis of accelerated depreciation is clearly erroneous and inconsistent with the legal analysis of the federal agencies who actually participated before the PUC.

2. Investment Credit. The Solicitor General's discussion of this issue appears at pages 12 through 13. In the case of accelerated depreciation, the Solicitor General avoided the statutory language and made reference to the regulations. In the case of JDIC, the Internal Revenue Service has been incapable of producing regulations. The Cities' analysis of JDIC is at page 20 of our brief and will not be repeated herein.

3. Plea for Utilities. The Solicitor General's concluding section is divided

into two paragraphs. The first paragraph, at page 13, properly recognizes that there is no conflict of decisions and therefore certiorari should not normally be granted. The second paragraph at pages 13 through 14 asks the Court to grant certiorari due to a fear of the potential financial impact on the utilities. The Solicitor General is clearly wrong in his analysis of the financial impact of the decisions. However, financial impact in no way provides jurisdiciton for certiorari. These paragraphs will be analyzed separately.

In the first paragraph, at page 13, the Solicitor General properly recognizes that there is no conflict of decisions and no basis to grant review under the Court's normal criteria. A fair analysis would be that there is not even a single decision, let alone a conflict of decisions, subject for review by the Court.

There is no dispute to which the Internal Revenue Service is a party. At page 4, the Solicitor General refers to a conflict between the "Treasury and the

state regulatory commission". There is no conflict. The IRS is not challenging the PUC in any tribunal. The PUC is not challenging the IRS in any tribunal. The IRS is not challenging Pacific or General in any tribunal. We simply have a case of a request for an advisory opinion. We submit there is no jurisdiction over this type of case.

Federal agencies undoubtedly would like someone, and in particular the Supreme Court, to interpret the law for them. With respect to accelerated depreciation, the IRS has conflicting standards. The actual audits of Pacific--for 1970-1973 by the IRS--produced no assessments. In responding to Pacific's request to be declared ineligible for the use of accelerated depreciation, Mr. Geoffrey Taylor writes a letter agreeing that there will be ineligibility. (Pet.App. D)

The attorneys representing the United States are clearly confused. The attorneys who participated in intrastate rate cases representing the interests of the United States advocate the method of rate making which the Solicitor General, in

representing the utilities' interests, now questions.

The IRS is even more confused on the issue of JDIC. Internal Revenue Code Section 46(f) was passed in 1971. The IRS has been unable to issue clarifying regulations. (P.App. E, 134A) Mr. Geoffrey Taylor issued several letters declaring that ineligibility will result if certain actions are taken. (R. App. D, p. 78RA) The Federal Energy Regulatory Commission found that Mr. Taylor has erred in his interpretation of the law. (FERC, Carolina Power and Light, Docket No. ER-76-494 (Phase II), Opinion 19, August 2, 1978, 15 Federal Power Service 5-619.) The IRS audits of Pacific confirm JDIC eligibility despite the fact that Pacific's rates are set out of conformity with the Taylor methodology.

The federal government is confused. The confusion of the IRS and the Solicitor General is no jurisdictional basis to grant a petition for certiorari. There is no case or controversy and all the Solicitor General seeks is an advisory opinion on the interpretation of a federal statute.

The Solicitor General, on behalf of the utilities, asks the Court to grant the petitions because he believes there will be a significant financial impact on "all regulated public utilities in California" and "other similarly situated companies" (p. 13). This statement is in error.

The limited impact of the intrastate California decisions was discussed in the Cities' brief at pages 21-23. The PUC decisions are only relevant in California to <u>Pacific and General</u>. Of all the utilities in California, only Pacific and General were imprudent in failing to adopt accelerated depreciation with flowthrough prior to the passage of the Tax Reform Act of 1969. (<u>San Francisco</u> fn. 3, 8 RA, 12RA.) This has significant factual and legal implications. The rate making treatment for Pacific and General is predicated upon the obstinancy and imprudence of Pacific and General. (San Francisco 11RA-15RA, <u>Los Angeles II</u>, fn. 12, 27RA)

The eligibility issue for Pacific and General arises only because Pacific's and General's tax status is predicated on Internal Revenue Code Section 167(l)(2)(B)

(P.App. C, 80A). This section permits Pacific and General to use accelerated depreciation only "if the taxpayer uses a normalization method of accounting". The prudent utilities in California (all but Pacific and General) which used accelerated depreciation with flowthrough prior to the passage of the Tax Reform Tax Act of 1969, are eligible to use accelerated depreciation pursuant to Section 167(1)(2)(C). This section provides that a utility may use accelerated depreciation "if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flowthrough method of accounting for its July 1969 accounting period." The other California companies need not use the normalization method of accounting to be eligible for accelerated depreciation. This case has no impact on the tax eligibility of other California utilities.

The Solicitor General at page 13 expresses concern about potential impact on "similarly situated companies" outside of California. We are unaware of the extent

of managerial imprudence and obstinancy throughout the country. In any case, whatever is adopted by California for Pacific and General is not binding in any way on other states.

The Solicitor General can point to no specific detrimental impacts of the PUC decisions. He can only speculate about potential problems for the utilities. (Solicitor General memo, pp. 3, 9, and 13; see footnote 2, p. 3 of this reply.) Regardless of the impact of the Commission decisions on the utilities, the issuance of an advisory opinion cannot be justified.

CONCLUSION

The plea of the Solicitor General on behalf of the utilities should be rejected and the petitions should be denied.

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APPENDIX A

LACK OF AUTHORITY TO ISSUE THE REGULATION

Judicial decisions regarding the validity of regulations issued by the Commissioner are multitudinous. The general standard can be stated in several different ways. Merten's Law of Federal Income Taxation, Volume I, Sec 3.21, states:

> The Treasury may not make an arbitrary or unreasonable Regulation, nor can it restrict or enlarge the scope of a statute. (Emphasis added)

47 CJS, Internal Revenue, Sec 48 states:

> However, to be valid, the rule or regulation must be reasonable, and must be consistent with the statute implemented, or not in conflict with the statute implemented as judicially construed. Moreover, the regulation must be confined within the general scope of the statute. (Emphasis added)

Some particularly pertinent language appears in Arkansas - Oklahoma Gas Co. v. Commissioner of Internal Revenue, 201 F.2d 98 (8th Cir: 1985):

> The Commissioner has no more power to add to the Act what he thinks Congress overlooked than he has to supply what Congress has deliberately omitted.

The preceding quotations appropriately frame the issue with regard to the proposed regulation. That is, does it impose a restriction not contained in the Act and thereby in effect enlarge the scope of the Act.

A. Primary Purpose Section 441 of the Act was to Prevent Tax Loss

House Report (Ways and Means Committee) No. 91-413, August 1969 (To Accompany H.R. 13270), in Part R, noted that at that time "about half the regulatory agencies require utilities that use accelerated depreciation for tax purposes to 'flow through' the reduction in Federal income taxes currently to the utilities customers." The report further noted that: (1) the "trend of recent years has been that regulated utilities previously on straight line depreciation have been shifting to various forms of accelerated depreciation"; (2) "at the same time, regulatory agencies which had previously permitted ... (normalization), have been shifting toward requiring (current flow throught)"; and (3) "several agencies have imputed accelerated depreciation in determining the Federal income

tax expense of the utilities, and flowed through the resultant tax deferrals, even though the particular utilities were in fact using straight line depreciation and in fact were paying greater current Federal income taxes...."

The Report also noted the fact that flow through results in a current tax revenue loss of approximately twice the amount of tax deferral and that this could shortly be a revenue loss of $1.5 billion to $2 billion and stated that: "Your committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow through is unacceptable at this time. (Emphasis added) Senate Report (Finance Committee) No. 91-552, November 21, 1969, contains an almost identical discussion regarding Section 441 of the Act.

Thus it becomes abundantly clear that the sole purpose of this section of the Act was to protect the Treasury from a large revenue loss as the result of flow through. The action taken was to effectively freeze the status quo and as to old property freeze a utility to its

current method of depreciation that it had been taking, and as to new property permitted accelerated depreciation only if the regulatory agency concerned permitted normalization of the deferred taxes. This, of course, means that the regulatory agency must (in determining cost of service) allow as an expense, the deferred taxes. In light of the tremendously adverse effect upon a utility's revenues, which would result from rates set upon a flow through basis and taxes being paid on a straignt line basis, regulatory agencies are effectively compelled by practical considerations to allow normalization. Thus Congress did not directly prohibit regulatory agencies from requiring or imputing flow through as had been the approach in H.R. 6659 (91st Congress) probably because of the Constitutional implications as noted by Chairman Mills who stated:

> I understand your legal point, that we have no right to tell you how to fix rates on intrastate matters in the State of California. I agree with you, that that would be an invasion of your right.

> Hearings on HR 6659, House Committee on Ways and Means, pg 3887, 91st Congress (1969).

While Section 441 may be as Constitutionally infirm as was H.R. 6659, it appears that Congress in trying to stem the revenue loss resulting form flow through, in both H.R. 6659 and in Section 441, directed its action only toward cost of service for ratemaking purposes, which is the only aspect of ratemaking which is affected by flow through and normalization.

B. Congress did not legislate regarding rate base. Congress did legislate with regard to income tax implications of regulatory treatment of taxes for the purpose of determination of cost of service for utilities, and if Constitutional, this may be a proper area for clarifying regulations, in light of the various methods of computing accelerated depreciation, and in light of the difference between FCC prescribed lines of property and tax lines. However, Congress appears to have specifically avoided any attempt to control directly or indirectly the treatment to be accorded by regulatory

agencies to any deferred tax reserve which would result from normalization. The House Report specifically noted that:

> Where normalization is used, this bill in no way diminishes whatever power the agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated. (US Code Congressional and Administrative News, 91st Congress, 1st Session, pg 1784).

The Senate report contains a similar statement of lack of intent. (U.S. Code Congressional and Administrative News, 91st Congress, 1st Session, pg 2205).

Thus it appears abundantly clear that Congress neither attempted to control, either directly or indirectly, the ratemaking authority of regulatory agenices to deal with the ratemaking treatment to be accorded the deferred tax reserve, as a condition precedent to being allowed to claim accelerated depreciation for Federal income tax purposes. This is, of course, understandable. To do so could be viewed as an invasion into the perogative of the states, prompt the possibility of judicial challenges, and in view of

the very small revenue effect which various ratemaking techniques might have on revenues, it was really not that much of a concern. The possible loss of $.15 per dollar of deferred taxes is much different from the loss of $2.00 per dollar of deferred taxes.1/

While this analysis is helpful in determining the extent of the intent of Congress, it unquestionably obtains, that Congress in determining and legislating as to what conditions must obtain before a utility is considered to normalize, addressed itself only to the subject of cost of service, and clearly avoided the subject of rate base.

1/ While each $1.00 of deferred taxes which is flowed through becomes a $2.00 tax loss, any error in computing the deferred tax reserve, which may be either deducted from rate base or treated as no cost capital in the capital structure, results in only a gain or loss of revenue to the utility (none to the treasury directly) of only $.15 on the dollar. Thus if the tax reserve is over or underestimated it results in only $.15 or thereabouts in revenue gain or loss per dollar. This $.15 represents the rate of return authorized to the particular utility plus the associated taxes on the eranings on common equity.

Judicial decisions concerning the regulation making authority of the Commissioner are legion and clearly in point here. In Busey v. Deshler Hotel Co., 130 F.2d 187 (6th Cir., 1942), the court said.

> To become binding, interpretive regulations must be reasonable and in furtherance of the intent of Congress, as evidenced by its Acts. Where the language of a taxing statute is plain and unambiguous, there is no occasion for resort to interpretive proclamations of the Treasury Department. Neither the administrative officers nor the courts may supply omissions or enlarge the scope of the statute. (Emphasis added)

In Smith v. Comm. of Int. Rev., 332 F.2d 671, 673 (9th Cir. 1964), the court said:

> The Commissioner may not prescribe any regulations which are not consistent with the statute; or which may add a restriction to the statute which is not there. (Emphasis added)

Another regulation was condemned in U.S. v. Marett, 325 F.2d 28, 30 (5th Cir., 1963) which said:

> This, it seems to us, is more than an attempt to put a 'gloss' on the regulatory requirement. It is an attempt to add a restriction to the statute which is not there. (Emphasis added)

Similar condemnations of regulations have been the subject of numerous court decisions, which will not be recounted here. Suffice it to say that, regulations issued by the Commissioner of Internal Revenue, must be confined to the scope of the statute and cannot add a restriction which Congress deliberately omitted. It is submitted that the proposed regulation, exceeds the scope of Section 441 in attempting to control the ratemaking treatment to be accorded the deferred tax reserve, a subject which Congress deliberately left in the hands of ratemaking agencies, and as a consequence would, if issued, be illegal.

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APPENDIX B

B.

POST SEPTEMBER 5, 1974 DECISIONS

Section § 1.167(l)-1(h)(6)(i) contains some very significant language. Speaking of the deferred tax return excluded from rate base, or treated as no cost capital, that paragraph states that the taxpayer does not use a normalization method of regulated accounting, if for rate making purposes, the amount of the reserve:

> ". . . exceeds the amount of such reserve for deferred taxes <u>for the period used in determining the taxpayers tax expense in computing cost of service for such rate making</u>." (Emphasis added.)

Voila! The period to be used to determine the deferred income tax reserve must only match the period used for determination of income tax expense, not the test period used for rate making purposes."

In subdivision (ii), it states:

> ". . . <u>if solely a historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes . . .</u>" (Emphasis added.)

Again the emphasis is that the period

used for the computation of the deferred tax reserve must match the period used for the computation of the depreciation for Federal income tax expense.

Continuing on to Example (1) which follows, it says in pertinent part, that:

> "The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service." (Emphasis added.)

This example certainly contemplates that the "test year" for all other purposes can be different than the test year utilized for determining Federal income taxes and the deferred income tax reserve.

V

CONCLUSION

From the foregoing, it can be readily seen that the only requirement of the regulations, as issued, is that the period used for the deferred income tax reserve be matched with the period used for income tax expense.

There is absolutely no requirement that the period used for revenues,

depreciation, and other expenses be coincident with the period used for taxes and the deferred tax reserve.

Consequently, the concept of a pro forma deferred income tax reserve is not impossible, it is not prohibited, but rather it is silently allowed. Silently in the sense that the regulations contain no specific example of its use or application. We are certain that this is not what Ma Bell wanted. But this is what has happened.

As a consequence, it clearly appears that two possibilities are present. First, if the decision in this, and the General Telephone Company case are issued before September 5, 1974, there is no question but what pro-forma normalization can be utilized. Second, as to future proceedings, the test year for revenues, depreciation, and other expenses need not be the same test year utilized for taxes and the deferred tax reserve, and in this sense, the deferred tax reserve can be on a pro-forma basis.

WHEREFORE, it is respectfully requested that this Commission:

1. Render a decision in this case prior to 5 September 1974, and consequently, avoid any question as to the utilization or a pro forma deferred Federal income tax reserve; or,

2. Reopen this proceeding in order to permit the Commission Staff and other interested parties to present evidence hearing upon the subject of the proper period to be utilized in this proceeding, for the purpose of determining Federal income taxes and the deferred Federal income tax reserve, which subject no party was on notice to address prior to the submission of this application.

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